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# How Labor Market Policies can Combine Workers' Protection with Job Creation: A Partial Review of Some Key Issues and Policy Options

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**Background paper for WDR 2005 “A Better Investment Climate – for Everyone”**

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**October 2007**

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\* Corresponding author: Stefano Scarpetta ([sscarpetta@worldbank.org](mailto:sscarpetta@worldbank.org)). Preliminary drafts of this paper have been discussed with a number of colleagues. In particular, we are grateful to Robert Holzmann, Gordon Betcherman, Amy Luinstra, Milan Vodopivec, Jan Rutkowski, Maitreyi Das, Margareth Grosh, Adriana Kugler, William Maloney, David Warren and the team of the WDR – 2005 for many useful insights. Amy Luinstra provided important material for our analysis of core labor standards, Jan Rutkowski helped with the assessment of labor market flexibility, Milan Vodopivec provided an essential contribution to our analysis of income support schemes and Victor Sulla contributed to the analysis of micro data. This paper has not undergone the review accorded to official World Bank publications. The findings, interpretations, and conclusions expressed herein are those of the authors and do not necessarily reflect the views of the International Bank for Reconstruction and Development / The World Bank and its affiliated organizations, or those of the Executive Directors of The World Bank or the governments they represent.



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## **A partial review of some key issues and policy options**

Background paper for WDR 2005 “A Better Investment Climate – for Everyone”

Gaëlle Pierre and Stefano Scarpetta \*

### *Abstract*

To what extent have macro and structural reforms in many developing countries affected the labor market? Are current policy settings in the labor market adequate to cope with the current challenges of a more dynamic but also more risky economic environment? Are there examples of successful labor reforms that have combined greater adaptability with greater workers' protection? What can labor policy do when resources are scarce and informality looms large? These are some of the questions we address in this paper by presenting an in-depth review of formal policy and institutional settings in the labor market of many developing and emerging economies. We also report some evidence of the effects of policy reforms on job creation and on the ability of workers to cope with shocks.

JEL classifications: E24, E26, J30, J38, J51, J65, J80.

Key words: labor markets, labor regulations, social protection, developing countries

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# **How Labor Market Policies can Combine Workers' Protection with Job Creation**

## **A partial review of some key issues and policy options**

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### **Introduction**

Our investigation on the role of labor market policies and institutions in developing countries starts with a simple consideration: Labor is the main asset of people, especially the poor, and it is an essential factor of production for firms of all types and sizes. The World Bank survey “Voices of the Poor” (Narayan et al. 2002) found that for more than 70 percent of the poor finding a job, whether salaried or self-employed, is the main way out of poverty. And in most developing and emerging economies about 90 percent of jobs are created by private firms. At the same time, even in high-tech manufacturing plants, labor plays a key role, and any innovation in the organization of production or in the quality and variety of products requires new skills and competencies. In this context, the way in which employers' demand for labor and households' supply of it interact is crucial in determining the conditions in which firms find the proper incentives for engaging in growth enhancing activities and workers fully participate in, and benefit from, these activities.

The interactions between labor demand and supply have been profoundly affected by global developments in the past decades. The transition of many developing countries and former centrally planned economies to market-based development, the greater integration of economies, with major improvements in the way goods and services flow across them, have changed the rules of the game within which businesses, the state and labor interplay. The opening of markets has exposed previously protected firms to greater competition. The scale of production has often changed, from large oligopolies protected by trade barriers, to smaller production units. Firms have gained access to new technologies and are facing greater pressure to innovate in order to survive and expand.

Shifting to a market-based and more open economy has created new economic opportunities, but also exposed firms and workers to new risks. Greater integration in world markets have enhanced opportunities for entrepreneurs to launch new activities and for existing firms to expand, both contributing to a faster job creation in expanding sectors. But technological changes and expanding international interactions have also threatened firms and jobs in declining industries. More generally, pressure has increased to make work arrangements more flexible to enable firms to adapt to changing economic conditions. While some countries have explicitly moved in that direction, others have resisted this pressure for greater labor market adaptability and, in some cases, have even reinforced mandated protection. In many countries where reforms have lagged, greater labor market adaptability has been channeled through a growing informal sector and downward flexibility in real wages. Since labor market policy and social security systems are often under-developed, many workers have increasingly be exposed the volatility of a more competitive, open but also more risky economic environment.

To what extent have macro and structural reforms in many developing countries affected the labor market? Are current policy settings in the labor market adequate to cope with the current challenges of a more dynamic but also more risky economic environment? Are there examples of successful labor reforms that have combined greater adaptability with greater workers' protection? What can labor policy do when resources are scarce and informality looms large? These are some of the questions we try to address in this paper.

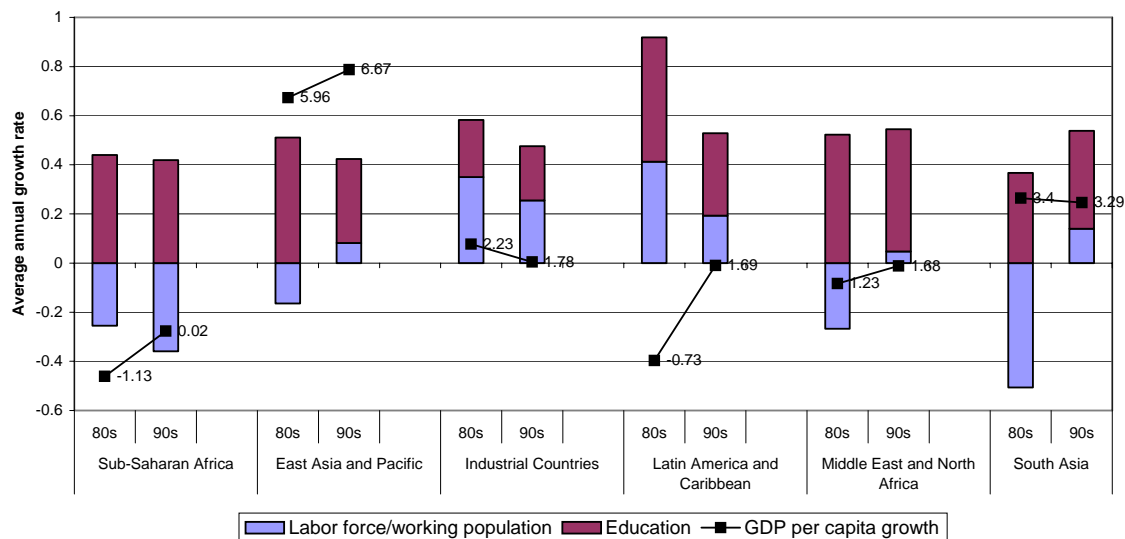
The structure of the paper is as follows. In Section 1, we review the evidence on the flexibility of the labor market in developing and emerging economies, and discuss how macro and structural changes have affected workers. In Section 2 we maps government laws and regulations in the labor market and assess their potential effects on workers as well as on firms' decision to invest and create jobs. Finally, in Section 3 we discuss the role of public policies in promoting the mobility of workers towards more productive jobs while also helping them to deal with labor adjustment and, more generally, unemployment risk.



## 1. Interactions between the investment climate and the labor market

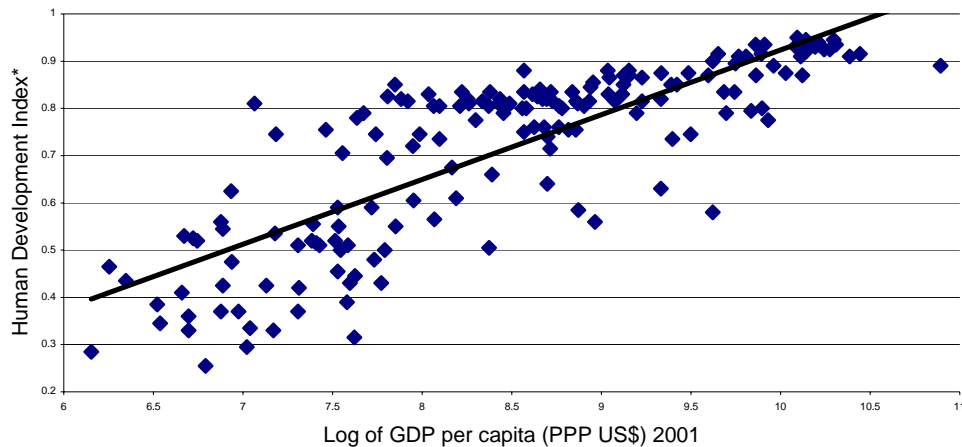
Efficient utilization of labor is essential for sustainable long-term economic growth and for poverty reduction. This entails high levels of employment, enhancement of human capital, and labor mobility. A simple decomposition of the sources of economic growth over the past decades suggests that the combined effect of greater utilization of labor and enhancement in human capital have generally made a significant contribution to improvements in output per capita. More interestingly, many countries that have seen improvements in their growth performance over the past decade have also seen improvement in the quality of the workforce and in some cases an increase in the employment rate (the share of the total working age population involved in productive activities) (Figure 1a). Even more importantly, household living standards, especially amongst the poor, are closely tied to their income from work, and a labor market that leads to high labor utilization, especially in formal activities, is a key vehicle to reduce poverty and exclusion (Figure 1b).

**Figure 1a: Growth in human capital and utilization of labor (1980s and 1990s)**



Source: WDI (2003) and authors' calculations based on Bosworth et al. (2003).

**Figure 1b: Higher growth means higher well-being**



\* Average of life expectancy and education indexes.  
*Source:* WDI (2003) and UN Development Report (2003).

While some countries – especially in East and South Asia – have been able to combine strong economic growth with an often rising labor utilization and enhancement of human capital, many others in the developing world have seen weak or even deteriorating labor market conditions. Often this is because private job creation has not kept pace with the increase in the working age population and/or the increase in female participation in the labor market. The most striking examples are in Sub-Saharan Africa, where despite some improvement in human capital, job creation in the formal sector has been largely outpaced by the increase in the working age population, leading to a further spread of informal employment.<sup>1</sup> Even stronger increases in population in the Middle East and North Africa have been coupled with greater participation of women in the labor market – from low levels – creating mounting pressure on the labor market.<sup>2</sup>

Moreover, falling employment and high unemployment have been a feature of many transition economies. While unemployment rates were practically nil at the beginning of the 1990s in most of them, they jumped to two-digit levels in the early phases of the transition to

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<sup>1</sup> See ILO (2002) for a review of the development of the informal economy over the past decade.

<sup>2</sup> According to a recent World Bank Study (2003a), between 1950 and 1990, 47 million workers were added to the labor force in the North Africa and Middle East region, but in the 1990s the labor force increased by some 31.6 million workers and another 42 million workers will be added in the current decade.

a market economy. Despite strong economic growth in some countries in more recent years, they are still often above 10 per cent (or even close to 20 per cent in Poland, Slovak Republic, and former Yugoslavia) and labor force participation rates have declined steadily. Many Latin American countries, including those with sustained growth, have also seen major rises in unemployment and inequality together with falls in participation rates: for example, the unemployment rate doubled to more than 10% in Argentina, Brazil and Chile in the 1990s and the share of working poor in total employment rose together with wage and income inequality in most countries. At the same time, while measured unemployment has remained relatively low in South Asia, the share of working poor has reached almost 40% on average in the region.

These unsatisfactory outcomes in the labor market are a source of major concern for workers and employers alike. Surveys of entrepreneurs in more than 80 countries have consistently shown that labor market restrictions are amongst the main obstacles for the operation and growth of businesses in many countries (Table 1).<sup>3</sup> At the same time, poor labor market conditions, including high and persistent unemployment and lack of employment and income stability, are the main concern of many people in developing countries, especially amongst the poor.<sup>4</sup> How much of these unfavorable outcomes for both employers and workers are due to poorly functioning labor markets, and how much is reflected in them, because of failures of other markets to promote growth?

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<sup>3</sup> These surveys ask managers of firms to rank eight areas – business licensing, customs and foreign trade restrictions, foreign currency and exchange regulations, labor regulations, environmental regulations, fire and safety regulations, tax regulations and their administration, and high effective tax rates – in terms of how problematic regulations are for the operation and growth of their companies. Labor regulations were perceived to be the major obstacle to business activity in Bangladesh, Brazil, Chile, Colombia, India, Namibia, Panama, South Africa, Thailand, Tunisia, and Venezuela. Portugal was the only OECD country where labor regulations are perceived as the major obstacle to doing business. Labor regulations were rated the second most important obstacle in Argentina, Bolivia, Botswana, Ecuador, Estonia, Mexico, Pakistan, Tanzania, Uruguay, and Zimbabwe, but also in Italy and Singapore. *Business Environment Surveys* were conducted in more than 80 countries by the World Bank over the 1999-2000 period.

<sup>4</sup> A recent participatory study conducted in 23 countries, gathered the opinions of poor people, most of whom pointed to increased unemployment and decline in the availability of “regular” or “normal” work as the main cause behind the deterioration of livelihoods and income. See Narayan and Petesh (2002).

**Table 1: Employers rank labor market regulations as a significant constraint to their business in most developing regions.**

	WBES		ICS	
	Labor Regulation Rank	Two most important issues	Labor Regulation Rank	Two most important issues
Sub-Saharan Africa	4 <sup>th</sup> out of 8	Taxes (level and administration) and customs regulations	17 <sup>th</sup> out of 18	Tax rates and Cost of financing
Europe and Central Asia	6 <sup>th</sup> out of 8	Taxes (level and administration) and customs regulations	14 <sup>th</sup> out of 18	Macro instability and Economic and regulatory policy uncertainty
Middle East and North Africa	4 <sup>th</sup> out of 8	Taxes (level and administration) and customs regulations	11 <sup>th</sup> out of 13	Access to finance and Anti-competitive or informal practice
East Asia and Pacific	3 <sup>rd</sup> out of 8	Taxes (level and administration) and labor regulations	12 <sup>th</sup> out of 18	Macro instability and Economic and regulatory policy uncertainty
South Asia	2 <sup>nd</sup> out of 8	High taxes and Labor regulations	13 <sup>th</sup> out of 17	Corruption and Electricity
Latin America and Caribbean	4 <sup>th</sup> out of 8	Taxes (level and administration) and customs regulations	10 <sup>th</sup> out of 18	Corruption and Economic and regulatory policy uncertainty

*Note:* WBES: World Business Environment Survey; ICS: Investment Climate Surveys.

On the one hand, high and persistent unemployment, a large informal sector or low participation may all reflect the inability of labor market to facilitate labor mobility and promote firms' investment, because of restrictions in wage or labor adjustments or low incentives for investment in human capital. On the other hand, the labor market may simply reflect problems in other markets which, by curbing firms' developments also limit the process of job creation and wage improvements. Some deterioration in labor market conditions may also be a temporary side effect of structural reforms aimed at improving the investment climate. For example, macro-economic reforms, trade liberalization or large scale privatization all require large reallocation of workers and changes in skills. Even in the best of all possible labor markets, such changes may lead to temporary increases in unemployment and loss of income, as workers need to change job, acquire new skills and sometimes change location. The issue is whether, in the longer term, there are equilibrating

forces in the labor and other markets that bring demand for workers in line with supply. In practice, it is difficult to disentangle these different elements as labor markets interact closely with other markets and reforms impose pressure on all of them also affecting these interactions. Bearing these caveats in mind, the remainder of this section will shed some light on these linkages in turn.

### ***How adaptable are labor markets in developing countries?***

Different factors contribute to the adaptability of the labor market and thus its ability to promote investment, job creation and growth. First, firms should be allowed to adjust wages and employment to changing demand conditions and to adopt new technologies. At the same time, market economies require a continuous reallocation of labor away from declining firms and industries toward expanding ones, and labor markets have a key role to facilitate this process and thus contribute to productivity gains and better prospects for workers. Developing and transition countries differ with respect to actual labor market adaptability, although lack of relevant information makes it difficult to depict a comprehensive picture.

Evidence suggests a significant – and often growing – response of wages to changes in labor market conditions in some countries. At the same time, in many countries a substantial number of jobs are created and destroyed every year pointing to a continuous process of labor reallocation. Both factors should be qualified: high downward wage flexibility may be related to unanticipated high (or hyper) inflation which expose workers to major income losses; and labor mobility may not contribute to growth and better conditions for workers if it involves large flows towards the informal economy.

### ***Real wage flexibility***

In many industrial countries, the elasticity of wages to local (or regional) unemployment is estimated to be around -0.10, i.e. an increase in unemployment from 5 to 6 per cent leads to a fall in real wages by 2 per cent. This elasticity varies widely across developing countries. In some of them, including Côte d'Ivoire and South Korea the responsiveness of wages to unemployment is weaker than that observed for industrial countries. In China, it is even positive, probably because regions characterized by rapid

economic and wage growth have attracted many rural workers, some of whom have not found a job and have instead joined the unemployment pool. By contrast, the reactivity of wages to unemployment in other countries – including several transition economies – is similar to that found in industrial countries, and even higher as in Brazil (Table 2).

**Table 2: Wages react to labor market conditions**

Country	Elasticity of wages to unemployment
Brazil	-0.25
Chile	-0.08
Côte d'Ivoire	-0.06
South Africa	-0.12 to -0.08
Bulgaria, Czech Republic, East Germany, Hungary and Poland	-0.09 to -0.04
Turkey	-0.07 to -0.09
South Korea	-0.04
China	0.08 to 0.09
Australia	-0.19
Austria	-0.09
Canada	-0.14
Canada	-0.09
Germany	-0.13
Netherlands	-0.17
Italy	-0.10
Norway	-0.08
Switzerland	-0.12
United Kingdom	-0.08
United States	-0.10

*Note:* The elasticity is the change in real wage as a result of a doubling in the unemployment rate. For example, in Côte d'Ivoire, a doubling of the unemployment rate leads to a 6 percent decrease in wages.

*Sources:* Hoddinott, 1996 ; Sabin, 1999 ; Blanchflower and Oswald, 1995 and 1998; Kingdon and Knight, 1999; Amadeo and Camargo, 1997; Berg and Contreras, 2002; Ilkkaracan and Selim, 2003.

It is noticeable that structural reforms have changed the responsiveness of wages to labor market conditions. For example, in Chile there was no evidence of the wage curve during the period of inward-led development (1957-1973), but the curve emerged along with

the opening of the economy and deregulation (1974-1996), with the regional unemployment elasticity of pay equal to  $-0.08$ . Similarly, in Romania, where market reforms have been less advanced than in Hungary or Poland, there is no strong relationship between the evolution of regional wages and unemployment rates.

It should be stressed, however, that the flexibility of real wages in many developing countries has often been achieved in the past by the lack of full indexation of nominal wages during periods of high (or hyper) inflation in downturns. In a low inflation environment and given the natural tendency for workers to resist nominal wage reductions, the ability of wages to accommodate demand fluctuations may be reduced. For example, wage elasticity in Argentina in the 1980s – a period of high inflation – was about 10 times higher than wage elasticity in the 1990s – a period of lower inflation – and employment elasticity in the 1990s was twice as large as employment elasticity in the 1980s.<sup>5</sup> In any event, wage adjustments may not be enough to accommodate changes in labor demand, especially in countries undergoing major structural changes, where new firms replace obsolete ones, new sectors emerge and new technologies have to be adopted to maintain competitiveness.

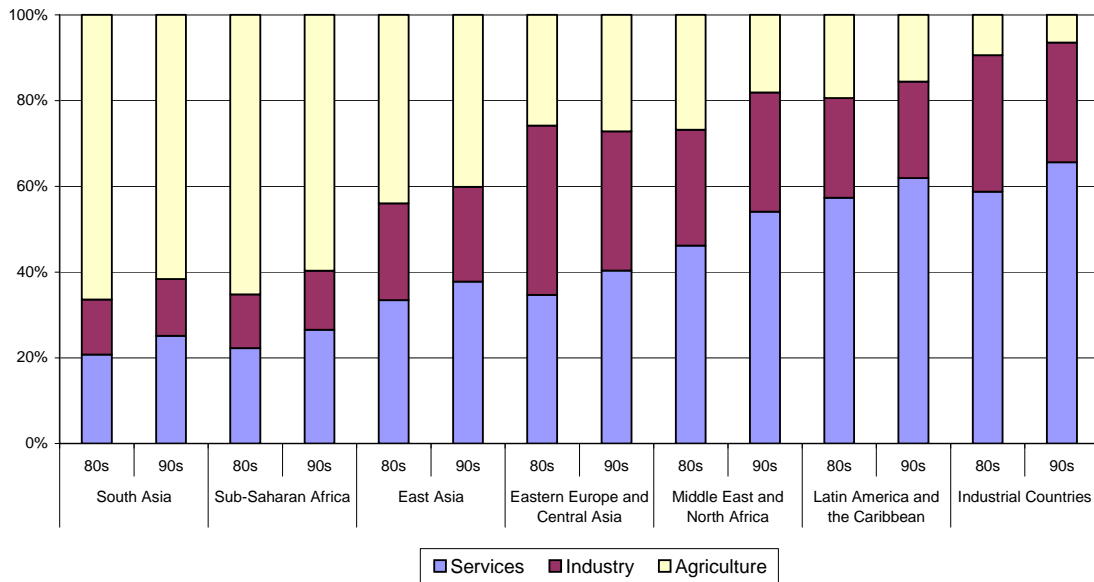
### ***Labor mobility***

At the aggregate level, most low- and middle-income countries have experienced significant shifts in employment, away from low-productive agricultural activities to manufacturing and, especially new service activities (Figure 2). The magnitude of the sectoral reallocation is particularly noticeable in the formerly centrally-planned economies, where service activities have flourished during the transition, most of the time at the expense of obsolete manufacturing firms. But significant changes in the sectoral allocation of employment are also visible in the Middle East and North Africa and Latin America. This secular trend away from agriculture and towards manufacturing and services hides significant differences in the ability to match labor demand and supply.

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<sup>5</sup> See IADB (2003).

**Figure 2: Sectoral decomposition of employment (1980s-90s).**



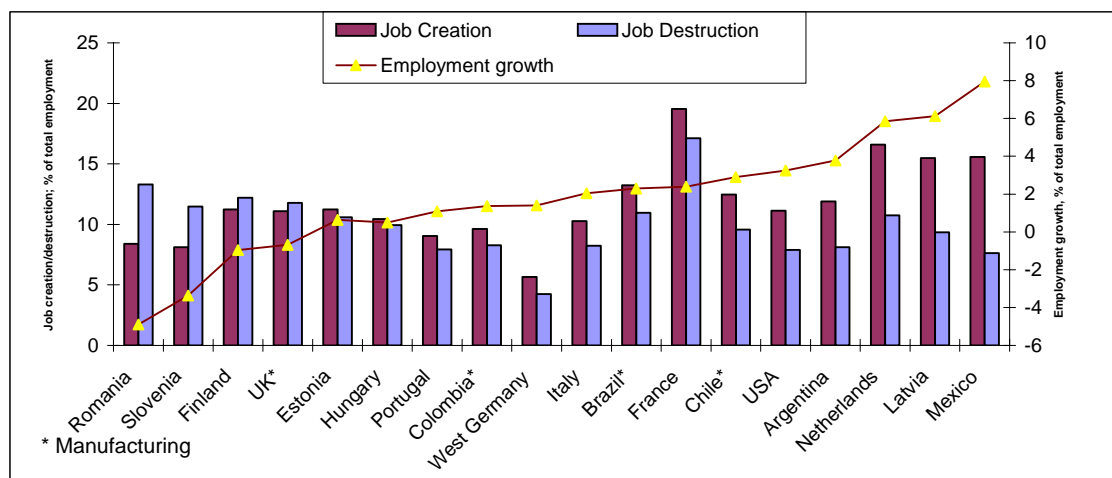
Source: WDI (2003).

In countries for which data are available, gross rates of job creation and destruction each range between 5 and 20 percent, adding up to a total job turnover of up to 40 percent (Figure 3). A significant fraction of this job turnover (often 30-50 percent) is due to the entry and exit of firms, an important factor for output and productivity growth (Figure 4).<sup>6</sup> This sizeable process of creation and destruction of jobs in most countries does not necessarily mean that the reallocation of labor is efficient. The latter depends on whether job flows lead to the allocation of workers to most productive use and thus are associated with productivity growth and wage increases.

<sup>6</sup> It should also be noted that in all countries, worker turnover is even larger than job turnover, because workers not only move directly from one job to another, but also between employment and unemployment and inactivity as a result of their own personal decisions. See Alogoskoufis and others (1995).

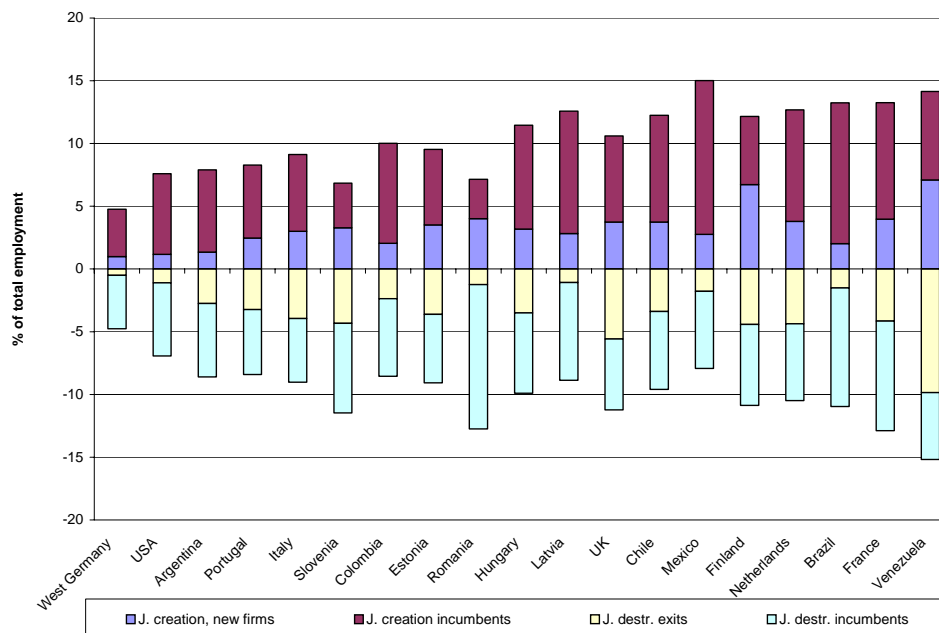


**Figure 3: Large job turnover in industrial and developing countries in the 1990s**  
(Firms with 20 or more employees)



Source: Bartelsman and others (2004).

**Figure 4: Job turnover is high because of the entry and exit of firms**  
Manufacturing sector



Source: Bartelsman and others (2004).

In particular, job destruction may be inefficient if, for example, capital markets constrain the ability of firms to cope with negative shocks and retain valuable workers. Credit constraints are a severe problem for small firms in many developing countries and it is thus not surprising that these firms tend to have higher levels of job reallocation.<sup>7</sup> Moreover, certain labor market policies may inflate job flows, without necessarily leading to better outcomes. The Brazilian labor market, for example, looks hyperactive from an international perspective, largely because workers induce dismissal to cash in their forced savings (in the form of severance payment) which will be otherwise depleted in real terms because of lack of indexation.

In addition, labor reallocation may go in the wrong direction, especially if dismissed workers cannot properly search for jobs because they cannot afford to remain without income. For example, in Latin American countries dismissed workers often go to the informal sector because the lack of unemployment benefits prevent them from properly searching for another (formal job).<sup>8</sup> And many workers dismissed by obsolete and closing-down firms in transition economies have returned to subsistence agricultural activities in those countries where job creation has been lacking. In Romania as well as in many Central Asian countries the share of total employment in agriculture has increased during the transition to reach more than 40-50 per cent of total employment in 2002.

### ***Internal and international migration***

The reallocation of labor towards more productive uses often involves large flows of workers across regions (rural-rural and rural-urban) and across borders. Both patterns are highly heterogeneous across countries and time and have played different roles in smoothing labor market pressures. Traditional models have emphasized the role of rural-urban migration as a key engine of development.<sup>9</sup> These flows are often very large: in a survey of 29 countries over the 1960s and 1970s, on average 39 per cent of urban population growth

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<sup>7</sup> See Caballero et al. (2003) for a discussion of the ability of different firms to adapt to negative shocks.

<sup>8</sup> See IADB (2003).

<sup>9</sup> See Todaro (1969); Harris and Todaro (1970). Amongst many others, see de Haan (1999) for review of the literature on the role of migration for growth and poverty reduction.

resulted from net immigration from the rural areas and reclassification of rural in urban areas.<sup>10</sup>

Whether these large domestic flows of workers smooth labor market pressures and contribute to a better allocation of resources depends on the characteristics of those who migrate and on policies that may influence the decision at the individual or household levels. Large flows of often unskilled workers are likely to increase unemployment in receiving urban areas if labor demand does not respond quickly. Immigrants in urban areas may be low skilled compared to the urban labor force, but they are generally young with relatively better education than the local workforce. Hence, emigration may reduce the potential for rural development if remittances towards rural areas do not compensate for the loss of human capital.

International migration may also be considered as a factor in promoting efficient allocation of resources, but, at the same time, may deprive a country of its main human capital assets. Two to three million people, often relatively highly skilled workers, are estimated to emigrate every year. This brain drain may reduce unemployment pressures in the short run in the sending country, but may as well impair its capacity to harness modern technologies in the medium to longer term. Indeed, some countries in Sub-Saharan Africa, the Caribbean, Central America and South Asia have lost around one-third of their skilled workforce because of out-migration.<sup>11</sup>

However, recent research also points to the benefits of emigration, in particular through the potentials offered by remittances and the role that returning emigrants may play for local development. Remittances have become an important aspect of global development finance. From 1995 to 2000, remittances rose from \$50 billion to \$88 billion.<sup>12</sup> Those remittances are used to support family members and can stimulate domestic demand as well local investment. Many relatively high-skilled emigrants also return to the home countries and establish their own business. Several East Asian economies have benefited from the return of migrants to the home country.

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<sup>10</sup> See Preston (1979) for a review of 29 developing countries over the 1960s and 1970s.

<sup>11</sup> See World Bank – WDR 1999-2000, Chapter 1.

### ***Reforms of the investment climate and labor market outcomes***

While a well-functioning labor market has a positive effect on investment climate, the opposite is also true: a well-functioning investment climate is essential to generate higher demand for labor and for enabling wages to rise. This idea is well accepted, but some of the key reforms to promote the investment climate are often perceived as harmful for the workers. Opinion polls in many developing countries, whether in Latin America, Central and Eastern Europe, Africa or even industrial countries, often reveal strong workers' dissatisfaction on the outcomes of these reforms for the labor market. Evidence suggests significant long-term benefits from a comprehensive reform of the investment climate, in terms of both access to better jobs and reduced unemployment and under-employment. Most of these reforms, however, imply major changes with short-term costs, especially for workers in firms previously protected by trade barriers, state support or lack of competition, and for those with low skills or in declining areas. Often, these costs are exacerbated by the fact that reforms are implemented in the aftermath of a major economic crisis when the choice of the reform package or its implementation occur when the economy is already undergoing painful adjustments.

### ***The long-term effects of reforms of the investment climate***

Reforms of the investment climate -- be it via enhancements in product market competition, greater transparency or more secure property rights -- have all the potentials for improving workers' welfare, although their effects depend on the reform package and may not be instantaneous. Successful reforms are expected to bring about higher wages and better working conditions, as well as higher employment and lower levels of unemployment and informality in the long-run (Figure 5a, b).<sup>13</sup> Empirical studies that have linked different structural reforms to labor market outcomes seem to confirm these points, although they also strongly underline the importance of a comprehensive and well tailored approach that is consistent with underlying economic conditions in each country. For example, countries which have opened their economies to greater foreign trade have enjoyed higher economic

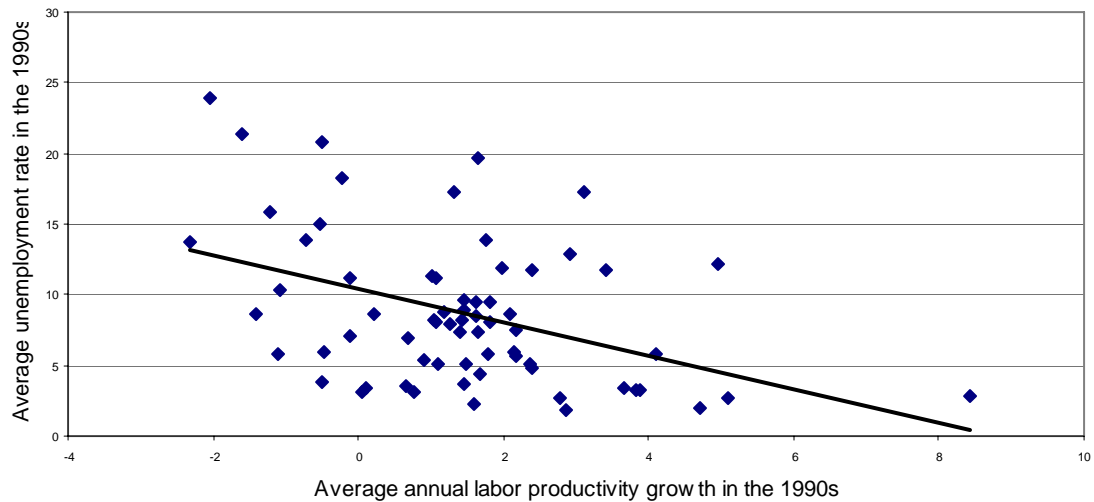
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<sup>12</sup> Ratha, Dilip. 2003. Workers' Remittances: An Important and Stable Source of Development Finance, Presentation for Poverty Day October 16, 2003. Washington DC: The World Bank.

<sup>13</sup> See Bourguignon and Goh (2003); de Ferranti et al. (2000); Gill et al., (2002a).

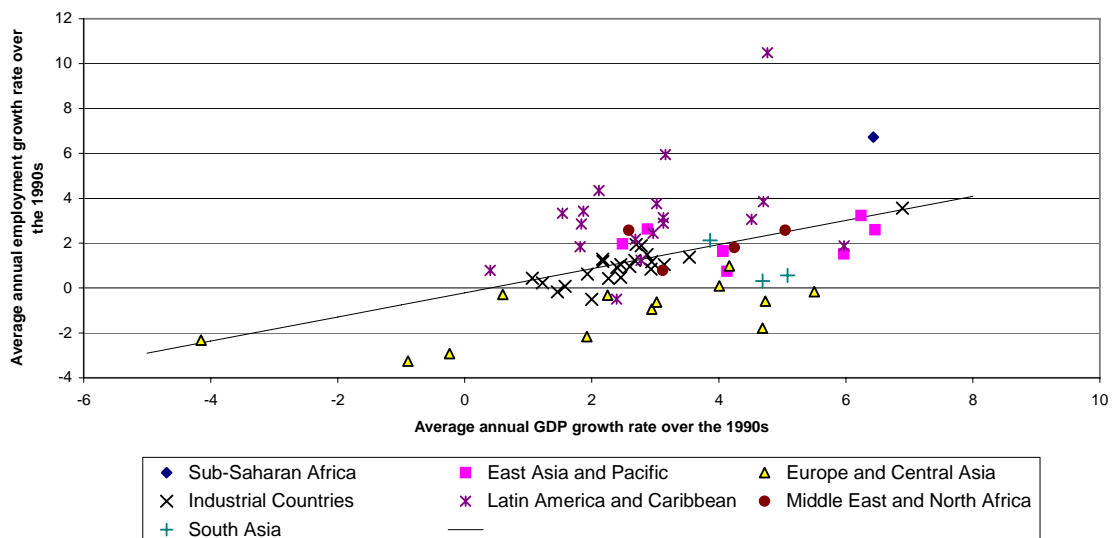
growth and higher wages compared to those which have persisted in the inward-oriented strategy.<sup>14</sup>

**Figure 5a: Successful reforms bring lower unemployment...**



Source: WDI (2003) and authors' calculations based on Bosworth et al. (2003)

**Figure 5b: ... and higher employment.**



Source: LABORSTA: National Labor Force Surveys (ILO)

<sup>14</sup> See amongst others, Dollar and Kraay (2001); Rodrik (1997); Freeman (1994); Matusz and Tarr (1999); Rama (2003).

Greater exposure to foreign competition strengthens incentives for firms to invest in new technologies and in enhancement of the human capital and skills of their workforce. Moreover, within each individual country, sectors exposed to stronger competitive pressure tend to have higher labor productivity and pay higher wages than those concentrated on the internal markets, even for workers of similar characteristics. De Ferranti et al. (2003) show that in Latin America both import-competing industries and export-oriented industries – i.e. those industries most exposed to foreign competition – tend to pay higher wages than non-traded industries as services and commerce, even after controlling for differences in human capital, education and experience of workers. This is because external competition stimulates the adoption of new technologies and these, in turn, require training and skill enhancements. In India wages were found to be higher in firms exposed to international competition, reflecting trade-induced productivity gains.<sup>15</sup> Similarly, there is evidence that foreign owned firms in developing countries tend to pay premium wages and provide better working conditions, which reflect their better productivity performance associated with foreign ownership and especially easier access to foreign markets and technologies.<sup>16</sup>

Trade liberalization, however, is often singled out as the main cause behind greater economic volatility and greater income and job security for workers. Open economies tend to be more exposed to fluctuations in global demand and to changes in relative prices. From a long-run perspective, there is little evidence that trade liberalization has led per se to an increase in the year-to-year fluctuations in earnings, nor are wages more volatile in sectors more exposed to foreign competition – a result which applies to a wide range of countries in Asia and Latin America.<sup>17</sup> At the same time, there is no strong evidence that, by fostering competition amongst domestic firms, countries have increased the elasticity of labor demand with respect to wages: no such effect was found in India, Turkey and a sample of Latin American countries.<sup>18</sup> Likewise, structural reforms that promote productivity do not per se lead to a widening of wage disparities over the long run. This holds true even if one looks at

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<sup>15</sup> See Epifani (2003).

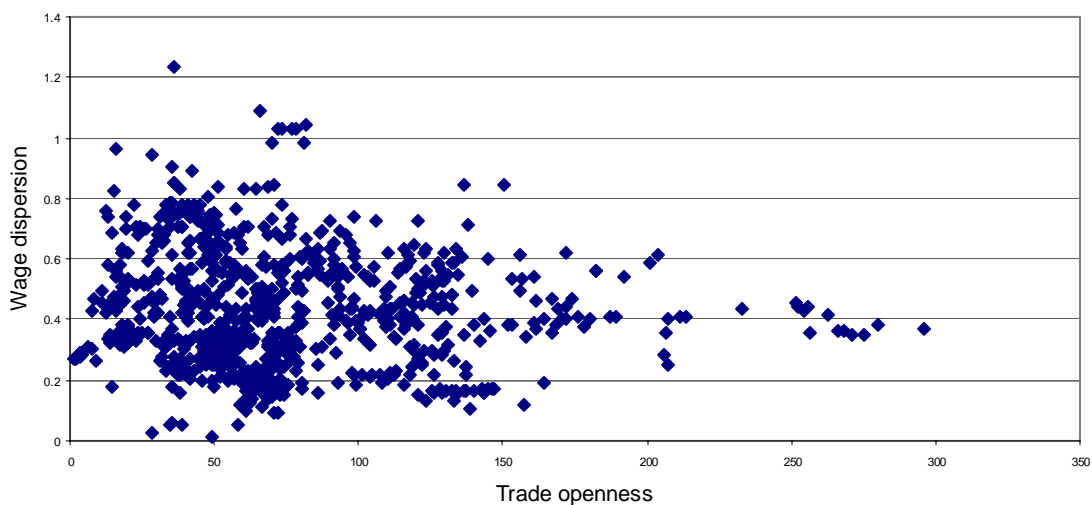
<sup>16</sup> See Brown et al. (2003).

<sup>17</sup> Bourguignon and Goh (2003); de Ferranti et al. (2000).

<sup>18</sup> Chinoy et al. (1999); Epifani (2003); Fajnzylber and Maloney (2000).

specific reforms such as an increase in trade openness (Figure 6a and b) or measures which increase the inflows of foreign direct investment. There is also little evidence that trade liberalization and product market reforms have been associated with the loss of many “good” jobs and the expansion of low quality and poorly-paid jobs. To the contrary, evidence indicates that jobs created in the emerging sectors appear to be better than similar jobs in the old sectors.<sup>19</sup>

**Figure 6a: Reforms do not necessarily widen wage inequality**



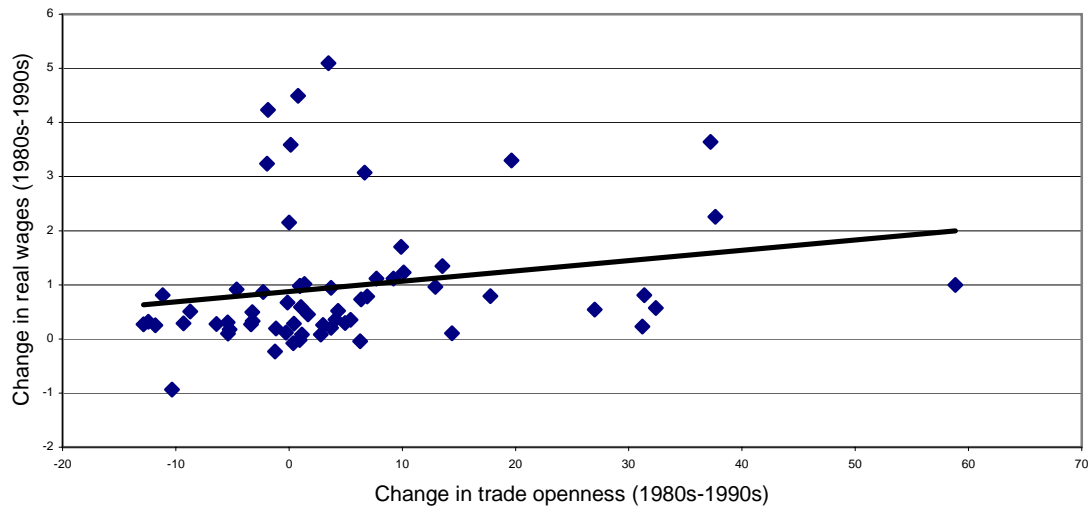
*Note:* This figure plots trade openness indicators against a standard measure of wage dispersion -- the standard deviation of the log wages of different occupations. Each point in the figure corresponds to a country (with a total of 113 countries) and year (over the period 1983 – 1999). See Rama (2003) for similar calculations.

*Source:* Freeman (<http://www.nber.org/oww/>) and WDI (2003).

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<sup>19</sup> See Gill et al. (2002a).

**Figure 6b: Reforms do not lead to declines in real wages.**



Source: Freeman (<http://www.nber.org/oww/>) and WDI (2003).

### ***The short-term adjustment costs.***

Many of the reforms aimed at improving the investment climate, however, may well imply changes in the nature of jobs, with a decline in lifetime employment with generous benefits in sectors sheltered from competition and lower job tenure. There are also short-term adjustment costs - in terms of employment losses and major changes in relative wages - associated with most reforms. These costs can be large and protracted if the reallocation of resources associated with most structural reforms is sluggish, because relative prices do not adjust, because labor adjustment costs are high or because old jobs are destroyed before new jobs are created. For example, empirical studies suggest that wages may well decline in the wake of trade liberalization, before they begin to rise again, usually at a higher pace.<sup>20</sup> These asymmetric changes in sectoral wages are also associated with possible short-run increases in wage dispersion, which tends however, to fade away over time.<sup>21</sup>

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<sup>20</sup> Rama (2003) suggests that the short-term effect of trade liberalization is negative while it becomes significantly positive over time. By contrast, the positive short term effect of FDI on wages fades over time. These two results suggest that if the opening up of the economy fails to attract FDI, there may be initial wage losses.

<sup>21</sup> Behrman et al. (2000) suggest, in particular, that capital and financial market liberalization tend to widen wage disparities between the high and the low skilled because skilled labor is complementary to capital and effective domestic capital market is likely to facilitate financing of both current production and productivity-enhancing investment.



Moreover, structural reforms prompt large reallocation of resources, including labor. Job destruction and job creation might not be fully synchronized. In many countries, and depending on the regulatory framework in product and labor markets (see section 2 of this paper), job destruction tends to proceed at a much faster pace than job creation. IC reforms could thus be associated with some temporary increase in unemployment, or the expansion of informal activities especially in countries where workers cannot afford to remain without a job. The point is however, that the high levels of unemployment emerging in the wake of economic reforms reflect the long adjustment periods, rather than final outcomes.

The short-term adjustment costs tend to be magnified if reforms are triggered by a crisis, as in Latin America after the debt crisis, in Sub-Saharan Africa following the sharp decline in commodity prices, or in transition economies after the collapse of the centrally-planned system. Adjusting to a fall in aggregate demand generally requires a decline in real wages. In countries where real wages fell significantly, unemployment and under-employment remained moderate, while in those where wage declines were moderated by institutional mechanisms, the adjustment cost largely manifested via higher unemployment. For example, Bolivia, Mexico, Indonesia, Russia and Ghana experienced large wage drops during their respective crises of the 1980s and 1990s with modest dis-employment effects, while in Chile, Argentina, the Republic of Korea and several Sub-Saharan African countries wage declines were less severe and the rise in unemployment was sharper.

### ***Who bears the burden of structural changes?***

The adjustment costs associated with most structural reforms of the investment climate tend to be borne by the most vulnerable groups in the labor market: those with low levels of education, or with a specialization which is no longer demanded in the market, and those with little work experience or in geographical locations dominated by backward activities. In developing and industrial countries alike, low skilled workers, youth and often prime-age women with little work experience tend to face a high incidence of unemployment, informality or low pay. These unfavorable conditions for vulnerable groups tend to deteriorate even further during the initial phases of large-scale structural reforms. Workers with little experience tend to be the first to be dismissed in case of downsizing and

the low skilled face the greatest difficulties if they lose their jobs. These difficulties can be particularly severe if the adjustment process follows a crisis that has plunged the economy into a recession or if the renewal of growth takes longer than originally expected.

Women tend to be significantly affected by structural changes. Those living in poor households are often asked, on top of their usual household responsibilities, to sustain household incomes when the wages of the male heads falls. In rural areas of El Salvador and urban areas of Mexico, greater women participation is the “coping strategy” to weather income shocks associated with the loss of male job. Moreover, when in the labor market, they often face higher unemployment risks than men, are disproportionally concentrated in low-wage sectors or occupations and often work in the informal economy. There are however, large differences across countries and regions on how women fare in the labor market. For example, in many countries of the Middle East and North Africa, women participation, although increasing, is still very low from an international perspective. Laws protecting women’s rights in employment are largely not enforced in the private sector and public enterprises. Moreover, family laws generally implemented in these countries mean that they are less flexible workers than men, and therefore less employable. By contrast, in many transition economies, women tend to have similar unemployment rates than men with similar education and the gender wage gap has even declined over time. However, the main concern for women in the region, as in most developing regions, is the tendency for working women to shift to informal economic activity.

More generally, workers with low skills tend to take most of the brunt of lower wages, unemployment and under-employment during structural changes. Evidence from Latin America suggests that wage differentials between the high skilled and the low skilled have widened significantly during the period of structural reforms of the 1990s.<sup>22</sup> In Brazil the probability of falling into poverty during an economic slowdown is around 25-30 per cent for workers with no formal education, while less than 5 per cent for those with higher

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<sup>22</sup> Behrman et al. (2000) suggest an increase of about 50 per cent on average of the gap between the wages of those with higher education compared to the wages of those with primary or lower levels of education.

education; and the probability of escaping poverty during an expansionary period is 10 per cent and more than 60 per cent, respectively for the two groups.<sup>23</sup>

The uneven risk of job losses and poverty across workers with different skills is the result of different forces influencing relative wages and job opportunities. Standard trade theory suggests that trade liberalization would stimulate the production of goods that used developing countries' presumed abundant factor of production, unskilled labor, and raise its relative return. At the same time, trade openness and other structural reforms have often increased access to new technologies which require high skills. These two forces play a different role depending on the economic context. In Latin America and in Central and Eastern Europe, skill biased technological changes seem to dominate, with a widening of wage and job disparities between the low skilled and those with higher skills. This is even consistent with the standard theory; albeit lower than those in industrial countries, wages of low-skilled workers in Latin America and Central and Eastern Europe tend to be high when compared with those of their counterparts in many South and East Asia countries.<sup>24</sup> More importantly, even when some least-skill-intensive part of the production process moves to developing countries, these processes are often skill intensive by local standards.<sup>25</sup> Moreover, technological change, however induced, appears to increase the demand for skilled workers. For example, evidence from Colombia, Mexico and Taiwan (China) suggests that firms investing in research and development or training of workers tend to have wider wage differentials between skilled and unskilled workers than firms that do not. In other words, the adoption of new technologies, which boost productivity and output growth, often requires skill upgrading. This leads to an increase in wage premium to education and consequently a widening of the wage gap between less and more skilled workers.

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<sup>23</sup> See Neri and Thomas (2000).

<sup>24</sup> See Wood (1997) for a discussion on this point.

<sup>25</sup> Feenstra and Hanson (1997); Attanasio et al. (2003).

### *The cost of inaction*

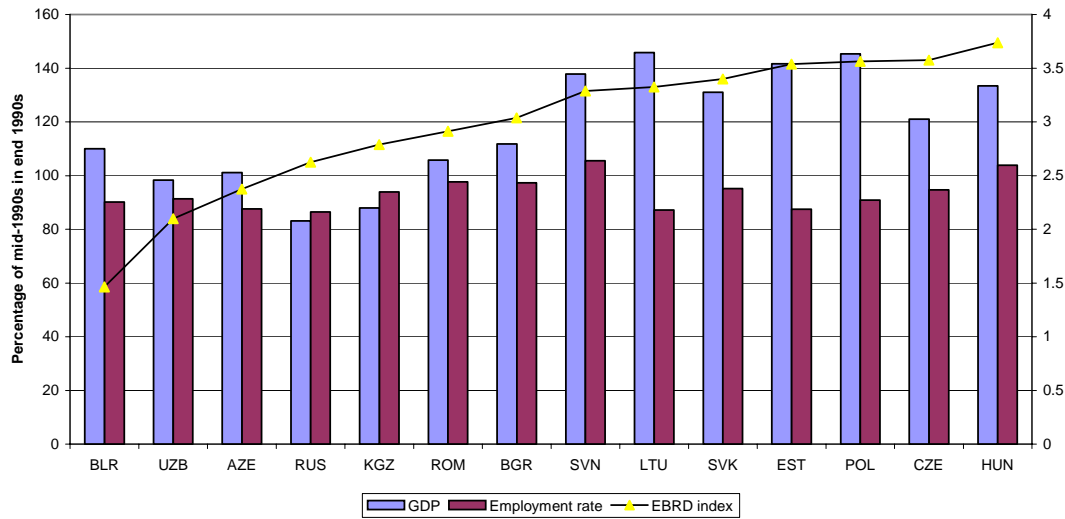
The magnitude and concentration of the adjustment costs associated with most structural reforms bear the question as to how to minimize them if not altogether avoid them by preventing or even reverting reforms. Avoiding structural reforms helps to avoid short-term costs of adjustment, but deprives workers of reaping the benefits of higher productivity and faster economic growth. Protecting the domestic economy from international competition neither leads to better jobs and working conditions, nor higher wages. As the figures above demonstrate, there are no visible benefits of non-participation in the globalization process while there are clear costs in terms of forgone opportunities. Lack of reforms seemingly preserves the status quo and maintains existing privileges. However, in the end, lack of reforms turns against the very interests of those whose welfare was meant to be protected. Economic hardship – rising unemployment or falling real wages – often reflect failure to carry out necessary reforms rather than the outcome of the reforms. For example, in Latin America it was the countries which failed to fully tackle the issues of macroeconomic stabilization and labor market rigidities, rather than those that opened up the most, that did not succeed in bringing unemployment down and fostering employment creation.<sup>26</sup>

Similarly, the transition countries of Central and Eastern Europe which undertook radical structural reforms at the outset of the transition have achieved considerably better growth and often labor market outcomes over time than countries where reforms have been incomplete or limited (Figure 7). In countries which successfully implemented radical reforms (e.g. Czech Republic, Hungary, Poland and the Baltic countries), the initial fall of output, employment and (to a lesser extent) wages was much deeper than in countries which have not taken the radical path (e.g. Belarus, Moldova, Romania, Ukraine). However, the bold reformers also experienced a faster and stronger recovery, witnessing strong output, wage and (to a lesser extent) employment growth. Wage inequalities have stabilized at a moderate level.

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<sup>26</sup> See Gill, et al. (2002a).

**Figure 7: The payoff of reforms in transition countries**



*Source:* EBRD Transition Report (various years); World Bank and ILO data.

*Note:* The EBRD transition index is obtained by taking the simple average of the EBRD indexes on Price Liberalisation, Forex and Trade Liberalisation, Small-Scale Privatisation, Large-Scale Privatisation, Enterprise Reform, Competition Policy, Banking Sector Reform, and Non-Banking Financial Institutions. These indexes are reported each year in the Transition Reports

At the same time, cautious reformers and non-reformers in Central and Eastern Europe have seen labor market outcomes gradually deteriorate. Underutilization of labor has been substantial (despite often low open unemployment) and, due to weak productivity gains, wage growth has been at best negligible. Governments in these countries have attempted to forestall job destruction and prevent mass lay-offs but this has come at the price of low productivity of many existing jobs and of low job creation rate in the new sector of the economy (consisting largely of small private firms, which are the most dynamic in terms of job creation). When job destruction could no longer be avoided, the lack of simultaneous job creation led to the build up of a large pool of unemployment and underemployment. As a result, the new dynamic sector in non-reforming economics is relatively small, which significantly limits opportunities for gainful employment. Limited access to high productivity jobs in turn tends to be associated with income inequalities. Thus, contrary to what one could expect, low unemployment in those countries does not imply good labor market prospects for workers.

The experience of Sub-Saharan Africa is also illustrative of the importance of maintaining macro and micro reforms over time to improve labor market outcomes. The dismaying growth performance in the 1980s triggered structural reforms in many countries of the region. These reforms often focused on the removal of impediments to trade such as high import tariff, subsidies import quantity controls and fixed exchange rates. The deregulation of domestic price controls was also implemented in many countries. Moreover, reforms of the public sector aimed at reducing the large but underemployed and poorly paid workforce in the public sector, therefore reducing the huge budget deficits that were needed to finance the wage bill.

All of these reforms were expected to improve incentives, and promote efficiency in production and thus lead to an expansion in output, employment and wages. In fact, while output has recovered in some countries, large downsizing of the public sector and strong population growth have not been matched by job creation in the private sector, leading to lower employment levels and real wage declines. Indeed, the expectations of better labor market outcomes as a result of structural reforms were based on the assumption that the private sector was ready to harness the potentials of a more open and competitive environment. However, weak and unstable institutions coupled with poor macroeconomic management often discouraged private sector initiatives. This is not true in all countries of the region. For example, in Ghana and Uganda, where reforms were implemented consistently, wages rose significantly. By contrast, wages stagnated in Kenya, where the reform program was implemented erratically and was subject to many reversals during the past decade. Likewise, in Côte d'Ivoire and Zambia, poor macroeconomic management led to high inflation and shrinking wages.<sup>27</sup>

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<sup>27</sup> See Dabalen et al. (XX) and van der Geest and van der Hoeven (1999) for a discussion of the labor market development in Africa during the structural adjustment period.

## **2. Governing worker-firm relations**

Policymakers intervene in the worker-firm relations on two main fronts. They set regulations for working conditions and the labor contract between workers and employers, and they fix wage floors and set the legal framework in which social partners operate. These interventions are theoretically justified by the (perceived or effective) inability of laissez faire conditions to deliver efficient and equitable outcomes. Efficiency arguments stress information problems and a need to promote matching between labor demand and supply. There may also be equity arguments if there is unequal bargaining power between employers and workers, potential discrimination against vulnerable groups, or incomplete or imperfect insurance of workers against risks. Interest group politics also play a role.

Beyond the core labor standards—the minimum framework for a sound labor market (Box 1)—government interventions need to strike a balance between the incentives for firms to hire and innovate, and worker preferences for job protection and income stability. This balance is influenced by social preferences in each country. But there has been a tendency in many low and middle income countries to over-regulate the labor market in an attempt to protect jobs. Indeed, many developing countries have labor regulations that mimic or even exceed those of industrial economies—even if the latter have approached these conditions only gradually during their process of development. Indeed, while one might expect a positive relation between the level of mandated labor protection and income across countries (i.e. labor protection is a normal good), the relationship is in fact negative across a large group of countries.

### **Box 1 The economic effects of core labor standards**

The international community has identified four core labor standards as the minimum requirement for all countries, whatever their stage of development: eliminating all forms of forced or compulsory labor, abolishing child labor, providing equal opportunity and nondiscrimination in employment, and ensuring the freedom of association and the right to collective bargaining. Most countries have signed conventions on forced labor and nondiscrimination, but a significant number of them have not signed those on the freedom of association and child labor.

The economic effects of enforcing core labor standards depend on the interventions and socio-political circumstances. Ensuring the freedom of association and collective bargaining can go a long way to promoting labor market efficiency and better economic performance. And there are obvious economic and social reasons for banning slavery and all forms of forced labor. But child labor and different forms of explicit or implicit discrimination, while generally perceived as violations of human rights, are still widespread in many low and middle income countries.

Child labor still looms large in the developing world, where one in six children between the ages of 5 and 17 are at work. Child labor hinders human development, reducing future earnings for the children themselves and aggregate growth potential of the economy. For example, children in India perform tasks that require no particular skills and develop no human capital. And cheap child labor, if combined with poor investment conditions, reduces the incentives for firms to invest in new technology that have higher productivity potential but require more skilled workers.

The timing and design of interventions to eliminate child labor are however crucial determinants of their success. Reforms that promote stronger economic growth are of tantamount importance. In Vietnam strong economic growth in the 1990s led to a significant rise in poor families' wealth which in turn contributed to reduce the number of children in the workforce by 28 percent. And improving the delivery of education (including targeted educational subsidies), which gains parental support, is generally more effective than an outright ban on child labor. Such bans are generally not enforced in many developing countries. A ban can also force child laborers into more dangerous, hidden forms of work (prostitution), especially where parents have no choice but to use child labor as a risk management tool.

Discrimination leads to the underuse and misallocation of human capital, creating inefficiencies and impeding economic growth. It can also weaken the economic position of households because they cannot secure more income if they need to. Household consumption may fall as a result of women's inability to find work (e.g. in Jordan).

*Source: ILO (2004); Burra (1995); Edmonds (2004); Krueger (1996); Brown (2000), OECD (2000), Martin and Maskus (2001); Miles (2002).*

If workers fully valued their benefits and were willing to trade them off for lower wages or greater effort, high levels of labor protection might not constrain firms' performance and job creation. But when heavy regulation is not fully accommodated by wages or higher productivity, labor costs are raised and firms face strong pressures to avoid them by recurring to informal arrangements. For example, in the middle-income countries of



Latin America, firms in the formal sector bear up to 50 percent of the non-wage labor costs.<sup>28</sup> The result is that many developing countries provide a relatively high standard of protection to a few workers but no, or minimal, protection for most of those in the unregulated economy. So while a small proportion of the workforce gain, it is at the expense of workers in the informal economy or the unemployed.

The sheer magnitude of the informal economy in developing countries (often accounting for more than 50 percent of total workers) underscores this point (Box 2). In many countries informal workers are a majority in the nonagricultural sector: they account for about 50 percent of total employment in Latin America, 45-85 percent in different parts of Asia, and more than 70 percent in Africa.<sup>29</sup> Evidence from several countries suggests that the size of the informal sector has increased in the past decade, with numerous workers moving back and forth between the formal and informal sectors. While some high-skilled workers may voluntarily opt out of the formal sector—to start a small business or to seek higher wages at the expense of unreliable social and health provisions—most informal workers receive lower wages and no or limited protection against old age, unemployment or sickness.

Striking a balance between protecting jobs or workers and promoting job creation by firms (the so-called efficiency-equity trade-off) is particularly contentious in a period of reforms when the long-term benefits of increased employment and wages are likely to be clouded by short-term concerns for the job and wage security of those affected during the transition. Successful reforms bring about higher wages and better working conditions—as well as higher employment and lower unemployment and informality in the long run.<sup>30</sup> However there are some short-term costs due to the changes in job characteristics and the greater labor mobility in a modern, productive economy. Those costs can be large and protracted if the reallocation of resources is sluggish—because relative prices do not adjust,

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<sup>28</sup> Heckman and Pagés (2004) estimate that workers absorb between 52 and 90 per cent of the cost associated to non-wage benefits in Latin America. Gruber (1997) found that workers bear all the cost in the United States. Mondino and Montaya (2004) for Argentina and MacIsaac and Rama (1997) for Ecuador suggest that compliance with labor regulations implies an increase in labor costs with possible dis-employment effects.

<sup>29</sup> See International Labor Office (2002).

<sup>30</sup> See Bourguignon and Goh (2003); de Ferranti and others (2000); Gill, Maloney, and Sanchez-Paramo (2002b); and World Bank (2002b).

because labor adjustment costs are high, or because old jobs are destroyed before new jobs are created.

**Box 2: The characteristics of the informal sector**

The informal or “micro and small-enterprise” sector is far from homogeneous. It includes *pre-entrepreneurial subsistence type of self-employment* which functions as “the employer of last resort”. This is an important source of household income supplementing farming income. This type of activities, however, is unlikely to be evolving in size and to eventually emerge in the formal sector. *Micro enterprises* are somewhat bigger operations, involving family workers and apprenticeships and using more modern technology albeit obsolete. They are more linked with markets for the provision of inputs and have some potential for growth and maturing into formal businesses. Finally, *small enterprises* with 10 to 50 workers use more advanced technologies and are often on the margin of the formal sector. They are combined with high-skilled self-employed who prefer to stay in the gray economy and avoid paying taxes. See Mead and Liedholm (1998) for evidence in six countries: Botswana, Kenya, Lesotho, Malawi, Swaziland and Zimbabwe

Recent evidence points to great mobility between formal and different types of informal employment. For example, in Mexico and Argentina, one-third and one-quarter of workers changing job, respectively, move from a formal to an informal job or from an informal to a formal job (Informal workers are defined as those who do not receive the benefits mandated by labor laws. See the *Inter-American Development Bank* (2003)). In many low-income countries, however, informality conforms more to the classical view of a residual segment of the economy: in Egypt, for example, more than 90 per cent of workers without contract of social insurance in 1990 were still in the same condition ten years later (World Bank, 2003a). Whether temporary or persistent, for most workers the shift from formal to informal jobs is involuntary and linked to lacking job opportunities in the formal sector. Only high-skilled workers tend to move voluntarily to the informal sector either to start a small business by their own or to seek higher wages at the expense of losing health and social security benefits. Maloney (2004) reports evidence from Argentina, Mexico and Paraguay suggesting that a large fraction of workers move to the informal sector because of more flexibility, higher wages, or simply the desire to become entrepreneurs. In markets with flexible wages, the cost of employer-provided benefits is also likely to be passed on to workers in the form of lower wages. If social security and health provisions are perceived as inefficient or if linkages between contributions and benefits are weak, workers may prefer to move to the unregulated market where remuneration is entirely monetary.

***Intervening in the wage-setting process***

The success of fostering opportunities for firms to invest productively largely depends on their ability to remunerate factors of production, including labor, according to their productivity and to adjust input prices to accommodate changes in demand. Properly compensating workers also fosters their effort in the production process and strengthens their incentives to invest in human capital. Governments intervene in the wage-setting process by establishing rules for wage bargaining and for industrial relations. These interventions can

reduce negotiation costs if they do not reinforce the monopoly power of the parties or impose rigidities in wage adjustments. Many governments also set wage floors in an attempt to reduce the number of working poor, but setting the floors too high can reduce the jobs available for lower skilled people and the opportunities for low-tech firms to emerge in the formal sector.

***Providing a legal framework for collective bargaining.***

The dialogue between freely elected (and representative) associations of workers and employers can reduce uncertainty and transaction costs and improve information flows.<sup>31</sup> In countries where collective bargaining is not available, agreements amongst social partners are often replaced by cumbersome regulations set unilaterally by the government. Collective bargaining offers a platform for involving both employers and workers in discussions with government about structural reforms. Consider the tripartite negotiations promoting macro and structural reforms in several western European countries in the past decade. Also consider the pivotal role of unions in promoting political openness and democracy in other countries, as with Solidarity in Poland and black labor unions in South Africa. However, under certain circumstances, unions may act as monopolists, improving wages and working conditions for their members at the expense of non-unionized workers and the economy.

Three main features of collective bargaining affect the flexibility of wages and the performance of firms. First is the bargaining power of unions combined with the monopoly rent that can be shared between firms and workers. The bargaining power of unions is generally measured by their membership. The latter varies across developing countries; it tends to be low in most of Asia and Africa, in part because many workers are involved in rural or informal activities, but fairly high in Europe. Unionization has generally been declining in the recent past (Figure 8). This is most notable in former centrally-planned economies where membership fell from covering almost all workers in the 1980s to a minority of them a decade later. Declines have also been recorded in other areas, including most industrial economies and countries in Latin America. This decline occurred largely because union membership was often concentrated in manufacturing and public services,

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<sup>31</sup> For a review of the role of unions see Aidt and Tzannatos (2002); Brown (2000) and Boeri and Calmfors (2001).

both downsized substantially in many countries.<sup>32</sup> Moreover, increasing competition, the expansion of small firms in services and the development of temporary contracts have also contributed to reduce unionization. Saavedra and Torero (2004) estimate that the drop in unionization in Peru from 40 to 30 per cent in the second half of the 1980s was largely due to decline in government employment and the expansion of temporary employment. The authors also suggest that after 1992 the diminished protection granted to labor unions in Peru was the main reason behind the even sharper decline in unionization.<sup>33</sup>

**Figure 8: Generalized reduction union membership**



Source: Rama and Artecona (2002).

The effects of unions on wages and economic conditions vary a great deal across countries and regions and largely depend on the economic and social environment in which they operate. Union wage markups tend to be fairly small in industrial countries<sup>34</sup> but quite high in countries with weak competition in output markets and large rents. Available

<sup>32</sup> However, governments in a number of countries grant administrative extension of union wage agreement to non-union workers (often referred to as *excess coverage*), which raises unions' power without forcing them to fully consider the economy-wide effects of wage agreement in their bargaining strategy.

<sup>33</sup> See also Zegarra and Ravina (2003) for a discussion in declined union density amongst teachers in Peru.

<sup>34</sup> The low union wage markup in most industrial countries is often due to the extension of collective agreements to non-union workers. France is the extreme case, combining the lowest unionization rate (about 9

estimates suggest high wage premia in Ghana (21-28 percent), Malaysia (15-20 percent), and South Africa (10-24 percent), but low premia in other countries, including the Republic of Korea (only 2-4 percent).<sup>35</sup>

Unions also tend to reduce disparities in the wage distribution, and union members tend to enjoy longer job tenure and receive more training than their counterparts. In a number of countries, employers favor dealing with them, as highly representative unions can deliver less industrial unrest and fewer strikes. However, some of these beneficial effects may come at the expense of those without jobs, especially if high union wage premia reduce job creation in the formal sector and if the poor mainly work in the informal sector.<sup>36</sup> The effects of unions on productivity are less clear-cut and depend on market conditions and industrial relations. For example, in Mexico unions have attempted to protect low-skilled jobs at the expense of higher productivity.<sup>37</sup> In Guatemala unionization is associated with lower productivity of coffee farmers.<sup>38</sup> Greater participation of workers in certain aspects of company management in Brazil contributed to better productivity and profitability. The effect was greater in unionized companies because unions facilitated communication between management and workers.<sup>39</sup>

An unstable political environment also tends to reduce incentives for unions to “invest” in wage restraint in exchange for better expected economic outcomes in the future.<sup>40</sup> High union wage premia and bigger drags on productivity are found in countries and sectors lacking competitive pressure. Investment climate improvements that enhance competition in output markets and economic stability are therefore likely to discipline union behavior into one more conducive to better outcomes for the economy.<sup>41</sup>

A second feature shaping the impact of unions on firms and workers is the extent to which direct government intervention influences their behavior and representation. In

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per cent of the workforce) with one of the highest coverage rate of collective agreements (about 85 per cent of the workforce). See OECD (1997).

<sup>35</sup> Aidt and Tzannatos (2002).

<sup>36</sup> Harrison and Leamer (1997).

<sup>37</sup> Maloney and Ribeiro (2001).

<sup>38</sup> Urizar and Lee (2003).

<sup>39</sup> Menezes Filho and others (2002).

<sup>40</sup> See Aidt and Tzannatos (2002) and Forteza and Rama (2002).

several Latin American countries, the state controls participation at the bargaining table and legitimizes agreements.<sup>42</sup> It defines what type of unions can organize and in some cases requires state authorization for a union to form. In Brazil only one union (*sindicato*) may exist in a given occupational category, and it has a monopoly in representing the corresponding workers. In Mexico more than one union can exist, but only certified union leaders can engage in collective bargaining or call a strike. Certification requires that unions be registered by the state. In Egypt and Syria union activity is limited to one officially recognized union or confederation, often with some political interference. In Zambia trade union unity is imposed on an enterprise, industry, occupational or geographical basis.

A third feature is the locus of negotiation and the coordination between different employers' and workers' organizations.

- *Enterprise.* At one extreme, wages are negotiated at the enterprise level, as in many English-speaking industrial countries. Decentralized wage bargaining ensures that wages reflect firm and individual worker performances. That leads to significant aggregate and relative wage flexibility but also to a wide dispersion of earnings—and possibly some transaction costs for firms if wages are frequently renegotiated.
- *Country.* At the other extreme, wages are negotiated at the national level among representative of employers, unions, and often the government. The experience of some continental European countries suggests that centralized bargaining may allow for the aggregate economic effects of wage agreements (employment, inflation) to be factored in the negotiation if social partners represent the large majority of workers and firms. This may ensure significant aggregate wage flexibility, but relative wage flexibility is often constrained, reducing the ability of firms to fully reward workers with firm-specific skills.
- *Sector.* Between the extremes, wages are negotiated at the sectoral level. This is common in Western Europe and in many developing and transition economies, where sectoral unions and employer associations negotiate wages for their sector or even for different occupations. Unless the different sectoral bargaining units coordinate their

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<sup>41</sup> See Calmfors (1993).

strategies—not frequent in developing countries—this bargaining regime may lead to limited aggregate and relative wage flexibility.<sup>43</sup> Why? Because each bargaining unit is strong enough to push wages above productivity but at the same time is vulnerable to other units' wage strategies without being able to influence them.

Over the past two decades there have been several attempts to improve the wage response to changes in demand conditions.

*Promoting coordination.* Some industrial countries with a tradition of collective bargaining have reinforced coordination among the different levels of wage negotiation (national, sectoral, firm). In some of them, such as the Netherlands, Denmark, and Ireland, nationwide agreements now fix only the basic wage increase, leaving to the firm-level negotiation further increases consistent with a firm's performance. Unions have also been part of the design and implementation of large structural changes in many countries. In Mexico and Israel, as well as in the Netherlands, Ireland, and Italy, unions have participated in the design of adjustment programs, including actions in the labor market, and agreed on social pacts that facilitated macro stabilization.

*Reinforcing firm-level bargaining.* Following the experience of other industrial countries—such as Australia, New Zealand, and the United Kingdom—some emerging and transition economies have reinforced wage responsiveness by shifting the wage bargaining to the firm level. In the Baltic States, Czech Republic, and Hungary unionization is low in newly created private firms, especially small ones, and wage bargaining takes mostly place at firm level.<sup>44</sup> Along the same lines, the wage bargaining system in Peru was reformed in 1992, increasing direct negotiation by relaxing the collective negotiation process, introducing voluntary arbitration as an alternative to state administrative decision, and eliminating state approval of agreements. The reform also increased collective autonomy by protecting unions' right to registration—and union pluralism by allowing more than one union to exist

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<sup>42</sup> See O'Connell (1999), Pencavel (1997).

<sup>43</sup> Strong coordination between unions and employers' associations in an industry or regional bargaining settings (as observed in some industrial countries, e.g. Germany and Austria and, more recently, Italy, Ireland, the Netherlands) may be an alternative, or functionally equivalent, to centralized systems, thereby mimicking their outcomes.

<sup>44</sup> See Haltiwanger, Scarpetta, and Vodopivec (2003).

in a firm.<sup>45</sup> In other countries, where informal activities still dominate, unions have expanded their intervention by helping informal workers get credit, improve their human capital, and obtain health support (see Box 3).

**Box 3 Unions have taken on new roles**

Given the reductions in union membership and the size of the informal sector, unions in many developing countries have started to expand their engagement with the informal sector. A union in Argentina operates a health insurance and unemployment fund that also covers unregistered and unprotected agricultural workers. In the Philippines unions initiated loan schemes for poor areas. An agricultural workers' union in Ghana includes self-employed rural workers as members, supports them through revolving loans, and facilitates their access to other forms of institutional credit. And an Indian union helps unorganized and self-employed workers to obtain licenses (Ratnam (1999)). In Sub-Saharan Africa unions have been active in dealing with the HIV/AIDS pandemic at the workplace.

Associations of informal workers have been created, with some taking a high profile role in defending informal workers' rights. Examples include the Ghana Private Road Transport Union and the Cissin-Natanga Women's Association of Burkina Faso, and the Self Employed Women's Association in India.

***Setting wage floors: the effects on low technology firms and the low skilled***

The main objective of setting wage floors is to promote decent jobs and reduce poverty among workers. They also tend to control market power that companies may have over individual workers who lack information, bargaining power or the ability to seek better-paid jobs. This is particularly the case in mono-cultural areas, where a single company may account for the bulk of labor demand. The effectiveness of wage floors in many low- and middle-income countries is however questionable. Minimum wages tend to be fairly high compared with market wages in these countries, and any further increase would shift the entire wage distribution upward. This concentrates the dis-employment effects among those they intended to support—young, low-skilled, and female workers. When enforcement is weak, a hike in the minimum wage stimulates more underreporting of wages or further incentives for firms and jobs to remain in the informal economy.

The minimum wage cuts the lower end of wage distribution and makes firms and jobs with low productivity levels unviable, at least in the formal sector. The level of the minimum wage affects firms, jobs, and income distribution.

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<sup>45</sup> See Eslava and others (2003).



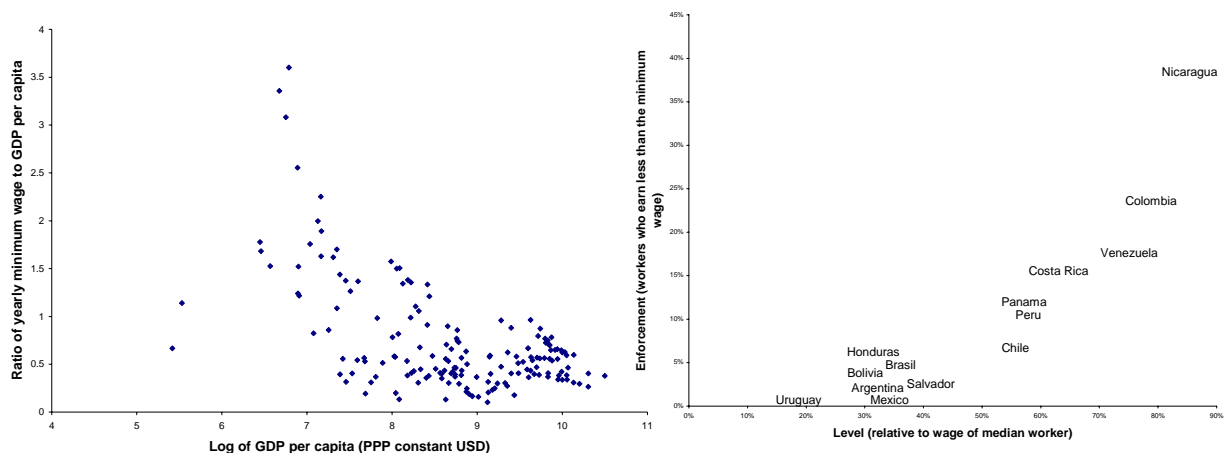
In industrial countries minimum wages tend to be relatively low (although in some cases may approach 50 percent of the median wage) with a modest impact on low-tech firms and the employment of low-productivity workers. Estimates suggest that in Colombia for every percentage point rise in the minimum wage, employment falls by 0.15 percentage points. See Maloney and Núñez (2004). In Indonesia, the significant increases in provincial minimum wages had some dis-employment effects in small firms, but not in larger firms, although it was also associated with an increase in the number of workers below the minimum wage. See Alatas and Cameron (2003).

In several low-income countries minimum wages are close to, if not higher than, the average wage (Figure 9).<sup>46</sup> At these levels, many private firms, especially those in low-tech activities, cannot afford to comply. This goes against the purpose of establishing a minimum wage as the poor tend to work in informal activities for only a fraction of the mandated minimum wage.

**Figure 9: The minimum wage is very high in many low income countries, and at high levels leads to weak enforcement**

*Relative minimum wage declines with income*

*High levels of the minimum wages lead to high evasion in Latin America*



*Note:* The wage used in the right panel for comparison is the median wage for workers between 26 and 40 years old that work for more than 30 hours in the reference period of the surveys.

*Source:* Left panel: Rama and Artecona (2002); Right panel: IDB based on countries official data.

<sup>46</sup> This is possible as certain workers are exempt from minimum wage laws and due to non-compliance in the informal sector.

In middle-income countries, the minimum wage is generally about half the average in the formal sector. Its coverage and enforcement tend to be low, but its impact on low-productivity firms and jobs can be large. In Latin America, for example, the largest proportions of workers who earn less than the minimum wage are found in countries where it is comparatively high—as in Paraguay, where the majority of workers earn less than two-third of the minimum wage, Nicaragua (40 percent of workers below the minimum), and Colombia (25 percent).<sup>47</sup>

Noncompliance with the minimum wage is concentrated among the most vulnerable workers. The minimum wage represents a higher proportion of the available wage for youths and other workers lacking work experience. In addition, it may be close to the underlying regional average in backward areas, severely affecting labor demand for small and medium firms that rely largely on low-skilled workers. For example, in Poland the national minimum wage accounts for over 80 percent of the going market wage in backward areas, contributing to high unemployment among low skilled workers, World Bank (2001a). Despite the low compliance, the minimum wage operates as a strong pay signal for the informal sector. This implies that hikes in the minimum wage can have distributional implications that go beyond the formal sector: the income of the low paid might increase in both segments of the economy, but the employment prospects for them might decline.<sup>48</sup>

*Graduating wage floors to promote the formalization of low-skilled activities.* Several countries have reduced the minimum wage relative to the average wage, largely by reducing its indexation and having lower subminima for some groups (young workers) or for subnational labor markets. The effects can be marked. For example, the erosion of the minimum wage in Mexico in the 1990s is estimated to have boosted female employment. Subminimum apprenticeship wages are available in many industrial countries (such as Belgium, Canada, New Zealand, Portugal, and Spain) and are being tested in several

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<sup>47</sup> The relationship between compliance and the level of the minimum wage is not one to one, as for most other regulations, and depends on the overall institutional climate and respect for laws, as shown in Continental European countries and Chile where high levels of the minimum wage are largely enforced.

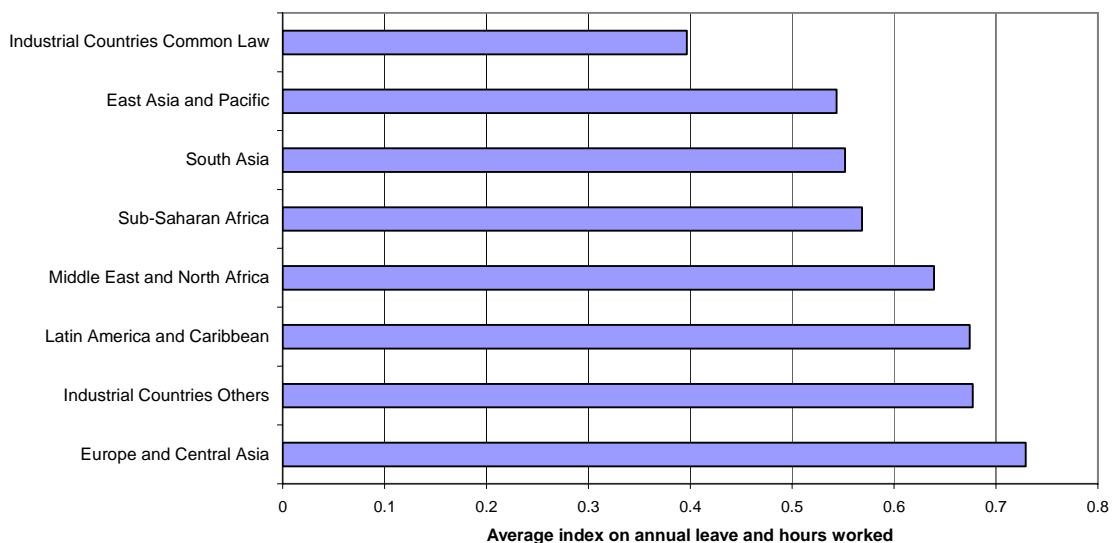
<sup>48</sup> For more details on the role of the minimum wage as a price signal for the informal sector in Latin America see Maloney and Núñez (2004) and World Bank (2004).

developing countries, including Chile and Colombia. They are estimated to have significantly increased job opportunities for young graduates in Chile.<sup>49</sup>

### ***Setting workplace regulations***

Promoting better health and safety conditions in firms, regulating working time, and encouraging paid annual leave have been major achievements in all societies. As in most other areas of public policy, improvements in working conditions in industrial countries have evolved gradually, hand in hand with more general economic progress. By contrast, many low- and middle-income countries have skipped the intermediate steps, and directly adopted far-reaching workplace regulations—in some cases going beyond what exist in many industrial countries (Figures 10 and 11, Tables 3 and 4). Even among countries at similar stages of development, the differences in workplace regulations are staggering (Figure 12A, B, C), with significant effects on labor costs and the ability of firms to accommodate fluctuations in demand.

**Figure 10: Most developing countries have stringent workplace regulations**

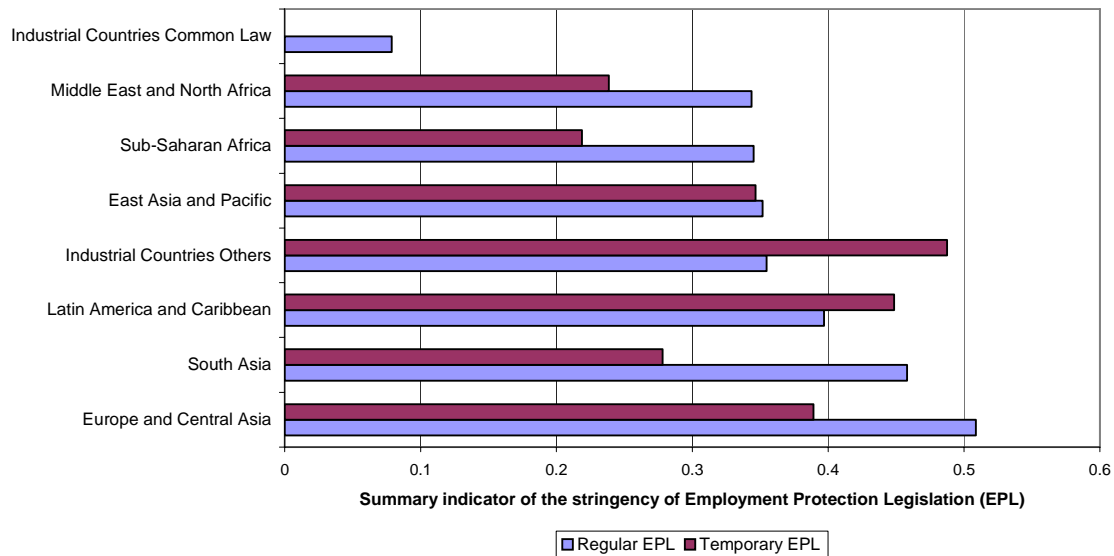


*Source:* Authors' calculations from *World Bank Doing Business Database (2004)*

*Note:* The index of condition of employment reported in this Figure is the normalized sum of: maximum number of hours in the workweek; overtime work, night shifts, holiday, hours of work, vacation days and whether paid time off for holiday is mandatory. The index captures what is written in laws and regulations and does not take into account possible cross country differences in the degree of enforcement of such laws and regulations.

<sup>49</sup> See Feliciano (1998) for Mexico and Gill, Montenegro, and Domeland (2002a) for the experience of Latin American countries that have introduced apprentice wages in the 1990s.

**Figure 11: Many developing countries have more stringent regulations on hiring and firing than industrial countries**



Source: Authors' calculations from World Bank Rapid Response Database.

**Table 3: Regular employment protection varies across countries.**

Legally mandated notice period for redundancy dismissal (in weeks) after twenty years of continuous employment				Severance pay for redundancy dismissal as number of months for which full wages are payable after continuous employment of twenty years			
Developing and transition countries (except high income)							
Least	Weeks	Most	Weeks	Least	Months	Most	Months
<i>Panama</i>	0	<i>DR Congo</i>	28	<i>Jamaica, Uganda.</i>	0	<i>Sierra Leone</i>	41
<i>Colombia, Fiji, Nicaragua</i>	2	<i>Lebanon</i>	17.3			<i>Lao PDR</i>	36
						<i>Brazil</i>	31
						<i>Guinea, Mozambique</i>	30
						<i>Egypt Arab Rep., Iran Islamic Rep.</i>	27
						<i>Sri Lanka</i>	25
Industrial (and other high income) countries							
Least	Weeks	Most	Weeks	Least	Months	Most	Months
<i>Puerto Rico, United States</i>	0	<i>Greece Germany</i>	32 28	<i>Belgium, Finland, New Zealand, Norway, Puerto Rico, Singapore, Sweden, United States.</i>	0	<i>Israel, Portugal, Taiwan (China)</i>	20

Source: Doing Business database (2005)

**Table 4: Temporary employment protection is low in many developing countries**

<i>Maximum duration of fixed-term contracts (in months)</i>			
<b>Developing and transition countries (except high income)</b>			
<b>Least restrictive</b>	<b>Months</b>	<b>Most restrictive</b>	<b>Months</b>
Albania, Bangladesh, Botswana, Cambodia, China, Costa Rica, Dominican Republic, Egypt Arab Rep., Estonia, Ghana, Haiti, Honduras, India, Iran Islamic Rep., Jamaica, Jordan, Kazakhstan, Kenya, Lao PDR, Lesotho, Malawi, Malaysia, Mongolia, Namibia, Nepal, Nicaragua, Nigeria, Oman, Papua New Guinea, Paraguay, Philippines, Poland, Saudi Arabia, South Africa, Sri Lanka, Syrian Arab Republic, Tanzania, Turkey, Uganda, Uruguay, Yemen Rep., Zambia, Zimbabwe.	No limit	Pakistan	9
		Bhutan, El Salvador, Morocco, Mexico, Panama, Sierra Leone	12
<b>Industrial (and other high income) countries</b>			
<b>Least restrictive</b>	<b>Months</b>	<b>Most restrictive</b>	<b>Months</b>
Australia, Austria, Canada, Hong Kong (China), Israel, Korea, Kuwait, New Zealand, Norway, Puerto Rico, Singapore, United Arab Emirates, United Kingdom, United States.	No limit	Sweden	12

Source: Doing Business database (2005)

Improving workplace safety is an important goal for all countries, and well-designed regulations can help to achieve this goal. The beneficial impact of such regulations may however be limited if they, or other features of labor regulation, have the effect of keeping firms and workers in the informal economy, where workers usually lack any statutory protection. Stronger enforcement can help in some cases. However, when regulations are out of step with local realities, there will be tradeoffs between providing a high level of protection to workers in regulated employment and reaching a broader group of workers.

Most countries have regulations for the workweek. Botswana, Chile, Costa Rica, Ireland, Malaysia, Morocco, the United Kingdom, and Vietnam all allow 48-hour workweek. Most western European countries have 40-hour limits, with France recently moving to a 35-hour workweek. To promote flexibility, some countries have revised regulations to allow managers to shift work time from periods of slow demand to peak periods. For example, Belgium, Finland, France, Greece, Hungary, Poland, and Spain leave to social partners to agree on the annualization of working hours.

In cyclical or seasonal industries, firms often use overtime work to accommodate demand. In Burkina Faso, Cameroon, Jamaica, Hong Kong (China), Spain, and the United Kingdom, firms do not have to pay a premium for overtime, while in Bangladesh, Belarus, India, Nicaragua, Pakistan, and Uzbekistan it is very costly, up to twice the regular pay.

The duration of paid annual leave is also subject to regulation. Many African countries have generous annual leave schemes—from 30 days in Burkina Faso to 33 in Ethiopia and 39 in Sierra Leone—but in most other countries paid annual leave is less than

30 days. Regulations in the United States leave the decision on annual leave to individual or collective agreements.

All these regulations improve conditions for workers in the formal sector and, by promoting better working conditions and motivation, can promote their productivity. Beyond any potential productivity effect, the impact on firm performance depends on who ultimately bears the costs. As discussed above, wages do not fully adjust to compensate for the additional costs for firms in many countries, reducing firms' potential for expansion and job creation. It could be argued that these negative effects may not be a source of concern if they reflect the rational choice of workers to trade off not only lower earnings, but also some unemployment, for greater security at work and decent working conditions.

A country would suffer from excessive regulation if lawmakers went beyond what workers were willing to pay or contribute in order to achieve these benefits. This issue is particularly relevant in low- and some middle-income countries where regulations are even more generous than in industrial countries. Those regulations might reduce wages below what poor workers would be willing or able to accept—and promote unregulated and unprotected employment, for which no control is available concerning workplace safety, and no protection against sickness, unemployment or ageing exist. In other words, overly ambitious mandatory benefit regulations result in good benefit packages for a few and no protection at all for the majority of workers.

### ***Balancing employment stability with firms' need to adjust the workforce***

Probably the most controversial government intervention in the labor market is setting rules for hiring and firing workers. By affecting the cost of workforce reorganization, employment protection legislation strongly influences the cost of doing business, but especially the incentives and opportunities for firms to exploit new technologies and expand. Legislation on temporary labor contracts -- fixed-term and temporary agency employment -- generally pertain to: (i) the types of work (e.g., occupations) for which these forms of employment are legal, and (ii) the maximum duration allowed. Restrictions on termination of contracts for workers with a permanent position can take various forms, including: (i) what is considered to be a justifiable reason for termination; (ii) severance pay

obligations; (iii) advance notice requirements; and (iv) administrative procedures for dismissing workers (including the role of trade unions). There may also be special requirements in the case of mass layoffs. These regulations are often found in national or sub-national labor codes but, depending on the country, the degree of employment protection can also be defined by court decisions, sectoral collective bargaining agreements, or even unwritten industrial norms.

### ***Regulating hiring and firing***

The protection offered to regular workers and the conditions for temporary employment vary considerably across regions (Figure 11) and within region (Figures 12A, B, and C). Countries in Latin America, Eastern Europe and Central Asia tend to offer the most employment protection for regular workers.<sup>50</sup> By contrast, “common law” industrial countries and East Asian economies have the lowest statutory protection.<sup>51</sup> Countries within each region set significantly different rules for temporary employment. Thus, Latin American countries and some Southern European economies restrict fixed-term contracts to specific tasks and/or limit the duration to one year, while several transition economies have recently liberalized temporary contracts. Cross-country differences are even larger on firing rules. Some countries, including Ghana, Israel and the United Kingdom have “contract at will” where the employment relation can be terminated by either party at any time. Most countries allow the termination of contracts under a list of “fair” causes, but the list can be very narrow, as in Bolivia where redundancy is not considered a fair cause for dismissal. Advance notice and severance payments range from a few days and a small proportion of the wage to several months and high compensation. For example in Sri Lanka, dismissed

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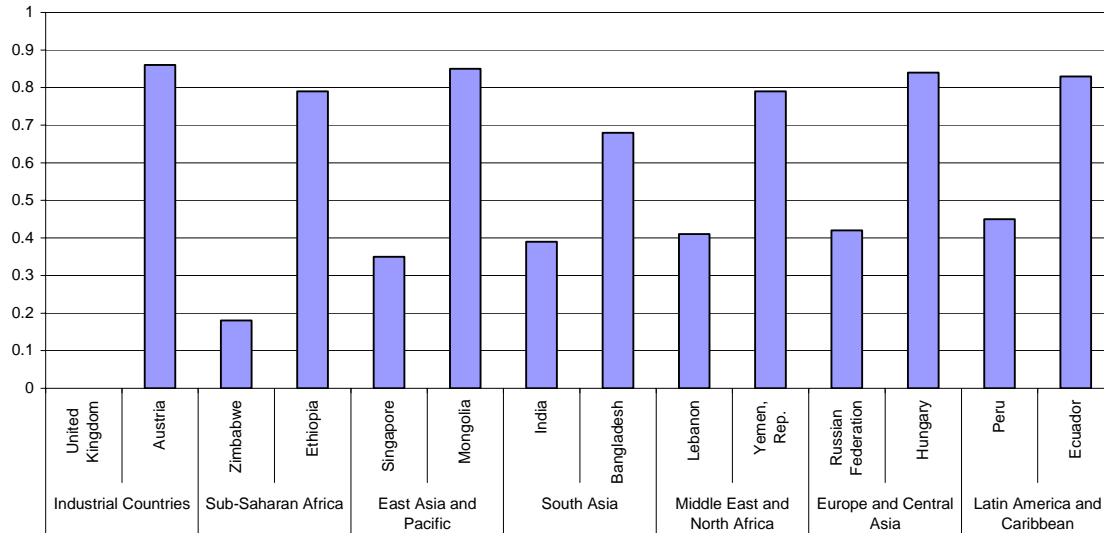
<sup>50</sup> Heckman and Pagés (2004) provide an alternative measure of job security that takes into account the monetary transfer that by law a firm has to pay to a worker on dismissal. This indicator confirms that dismissing a worker in Latin America involves a larger mandatory transfer to the worker than it would in industrial countries.

<sup>51</sup> The synthetic indicator of the strictness of regulations in case of dismissal of workers with permanent contracts is the normalized sum of the following components: i) procedural inconveniences that employers face when trying to dismiss a worker; ii) notice and severance payments; iii) prevailing standards of and penalties for “unfair” dismissals; and iv) procedures that employers must follow and approval they must seek prior to collective dismissals. Indicators of the stringency of EPL for temporary contracts refer to: i) the “objective” reasons under which they could be offered; ii) the maximum number of successive renewals; iii) and the maximum cumulated duration of the contract. For information on the underlying data see Djankov and others (2003) and World Bank (2003b).

workers receive 2-3 months of salary for each year of service, and severance payments in some cases exceed 40 months' wages.

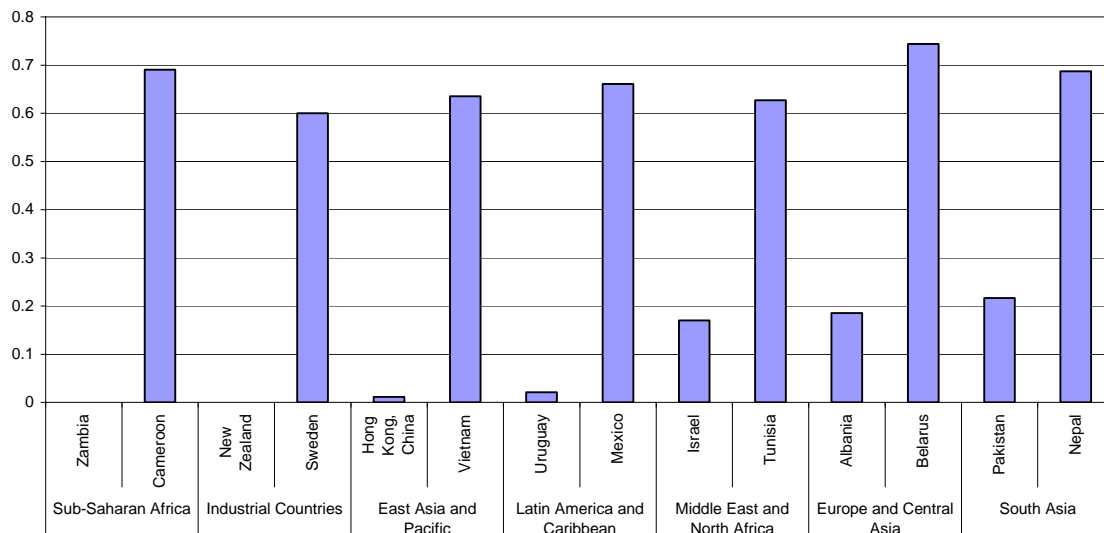
**Figure 12: Labor market regulations disparities within regions**

*A. Working Conditions*



*Source: Authors' calculations from World Bank Doing Business Database (2004).*

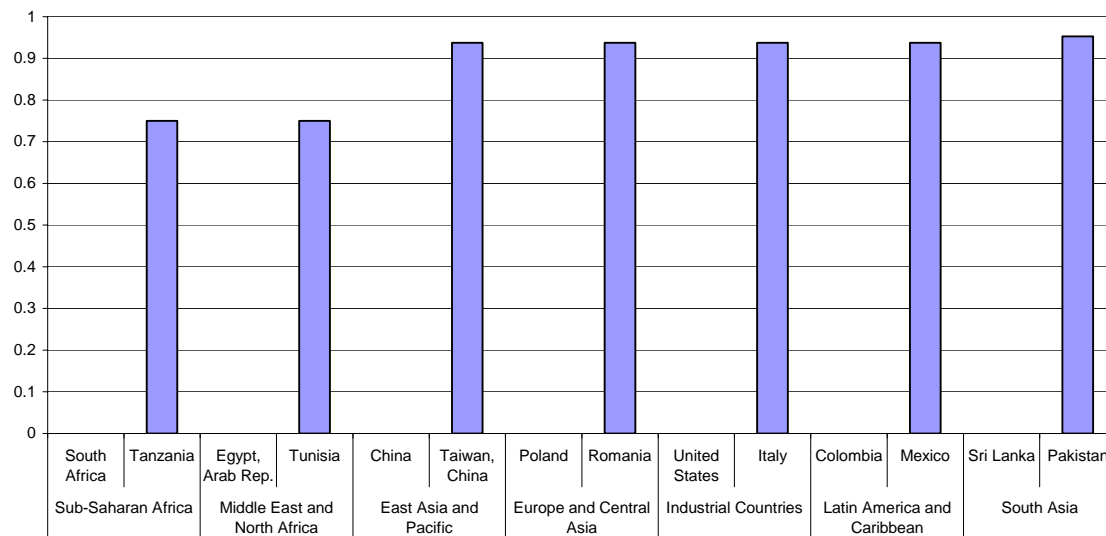
*B. Regular Employment regulations*



*Source: Authors' calculations from World Bank Doing Business Database (2004).*



### C. Temporary Employment regulations



Source: Authors' calculations from World Bank Doing Business Database (2004).

Procedures for dismissal are often cumbersome and opaque. In Sri Lanka the government decides the amount of compensation for laid-off workers and has the authority to reject employer demands. The time needed for processing the request for a layoff can be highly unpredictable, taking on average six months but much more if the procedure involves hearings where employers explain their financial performance and business plans to the government to justify the layoff. In Russia, before the reform of the labor code, trade unions had veto power over dismissals for staff reductions or for employees not suited to the job.<sup>52</sup> In Brazil representatives of employers and workers used to sit on the jury of labor courts, a practice that often led to protracted judicial procedures and difficulties in reaching compromise. Because of the complexity of the severance pay schemes, more than 6 percent of all salaried workers (about 2 million) usually file a lawsuit every year. Before 1999 the average labor dispute usually took almost three years. A change that year restricted the jury to professional lawyers and cut the time to resolve a dispute by half.<sup>53</sup>

<sup>52</sup> See World Bank (2003e).

<sup>53</sup> See World Bank (2002a).

#### **Box 4: Labor regulation and global integration**

Differences in labor regulations and their enforcement might give a cost advantage in internationally traded goods to countries with weak regulations. And new technologies allow labor services to be directly subcontracted to workers in countries with less stringent regulation. This has led to concerns that multinational companies are taking advantage of weak labor regulations or putting pressure on governments for not enforcing existing regulations. And advocacy groups have launched boycotts and other demonstrations against this, especially against firms in apparel and footwear.

*“Race to the bottom”?*

Evidence of noncompliance with labor regulations abounds in low and middle income countries. But there is no clear evidence that this is related to greater integration in the world market. This is true whether greater integration is measured by export market shares, revealed comparative advantages, foreign direct investment, or trade prices. And trade sanctions have been shown to be counterproductive, potentially harming the people they aim to protect.

Even in export processing zones—which have often been seen as attempts to promote investment by local and foreign firms by offering regulation-free conditions—there is not overwhelming evidence of suppressed labor rights, at least no more than what is observed outside the zones. Of 73 zones reviewed in a recent study, in only six was there found to be any deliberate attempts by government to restrict workers’ rights.

*Or better contracts for workers?*

A body of evidence suggests that multinational firms are providing better working conditions, paying higher wages than alternative local employment, and do not suppress workers’ rights. The World Bank’s Productivity and Investment Climate Surveys also suggests that foreign-owned firms tend to have a larger share of workers with permanent contracts and to provide more training opportunities to their workforce.

Multinational firms also favor countries with a stable political and social environment, in which civil liberties are well established and enforced. Such environments are typically more conducive to laws being applied evenly to foreign and domestic firms. Moreover, many multinationals are burnishing their reputations by establishing codes of conduct, in line with existing standards or codes.

From a review of 246 voluntary codes of conduct of firms, it appears that the treatment of labor issues varies across codes, from mentioning them in passing to committing to specific actions, such as creating a reasonable working environment and complying with the law. Compliance with codes is monitored by the buyers and often by the independent social auditors they hire.

Poor working environment conditions are, however, the reality of many workers at the end of the supply chain. And only recently have some multinationals revised their purchasing practices and improved compliance with labor standards by local subcontractors.

*Source: OECD (2000), Krumm and Kharas (2003); Basu (1999), Maskus (1997); OECD (2000); Brown, Deardorff, and Stern (2003); World Bank (2003d); OECD (2001); Raworth (2004)*

Minimum standards for hiring and firing procedures can benefit both workers and firms (Box 4). For example, by reinforcing job security, they can enhance productivity, as workers will be more willing to cooperate with employers.<sup>54</sup> To the extent that job protection

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<sup>54</sup> See amongst others Akerlof (1984).

leads to long-lasting work relationships, it may encourage employers to provide training. A better skilled workforce may also increase internal flexibility and thus lead to a better functioning of production activity.<sup>55</sup> Job protection may also be a way to internalize the social costs of dismissals by moving the social burden of re-allocating a worker to another job closer to the firm's profitability criteria.<sup>56</sup>

Given the high level of protection granted to workers in the formal sector in many developing countries, it is not surprising that managers often consider such regulations as a major obstacle for the expansion of their firm. When asked to evaluate eight areas for the burden regulations impose on the operation and growth potential of their business, they ranked labor regulations as the major or second-most important obstacle in many countries of Latin America, Central and Eastern Europe and South Asia. There is a close correlation between managers' perceptions of employment regulations and the stringency of such regulations from an international perspective (Box 5).

In fact, overly stringent regulations — those at odds with the international experience and with the stage of development of the economy — affect different aspects of firms' performance, including spending on innovation, the entry of new firms, their average size, and the incidence of informality.

Cost of doing business and exploiting technological opportunities. Overly strict hiring and firing rules tend to raise the cost of workforce reorganizations, reducing incentives for firms to innovate and adopt new technologies. Evidence from industrial countries suggests that stricter rules are associated with lower R&D expenditure and tend to tilt specialization away from high-tech industries. A cross-country study suggests that by reforming their labor rules to the OECD average, countries with very strict employment regulations could reduce their productivity gap with the technological leader by about 20

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<sup>55</sup> See amongst others Piore (1986).

<sup>56</sup> See amongst others, Lindbeck and Snower (1988).

percent.<sup>57</sup> Similar reforms in developing countries can yield even larger productivity gains, given the greater potential for adopting technologies available in international markets.

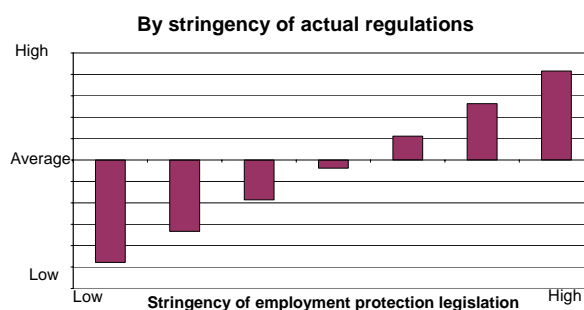
#### **Box 5 Do employers' perceptions square with actual labor regulations?**

Two main approaches have been used in the literature to assess the importance of regulations in different markets. The first is based on international comparisons of formal laws and regulations aimed at benchmarking countries and identifying best practices. When noncompliance with regulations is high—as in the case of labor regulations in many developing countries – international comparisons may give rise to inaccurate assessment. Moreover, labor laws are often complex and interact with other government regulations. The second is to ask those directly affected by specific regulations, employers and workers. But perceptions are subjective and likely to depend on national and cultural and on the stage of the business cycle. Cross-country comparisons therefore remain difficult with these subjective evaluations.

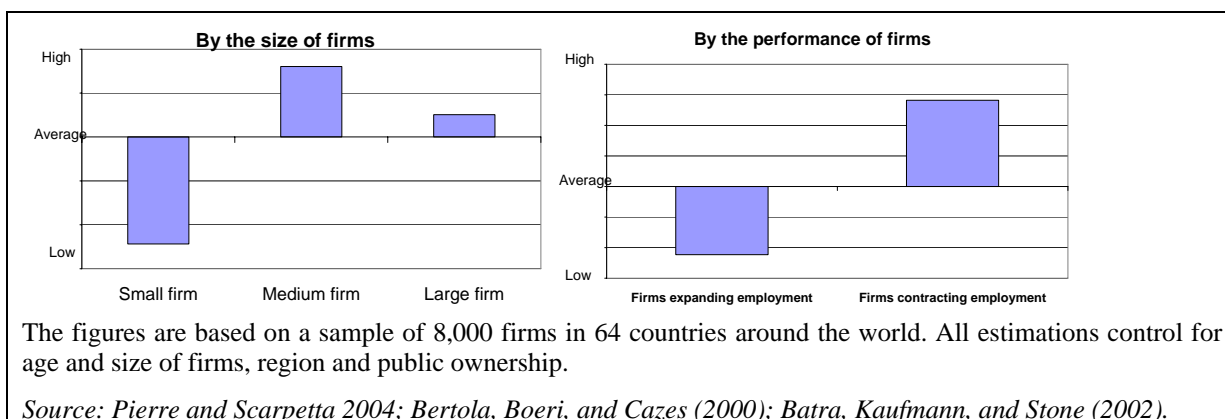
The *World Business Environment Survey* of the World Bank ask managers how problematic they found regulations in different areas, including labor, for the operation and growth of their companies. The survey focuses on 73 industrial and developing countries. Overall, the raw data suggest that close to 70 percent of respondents reported some concern (minor, moderate, or major) about labor market regulations. Around 15 percent report that these regulations are a major obstacle to the operation and growth of their business.

These data on how employers perceive labor regulations were combined with an indicator of the strictness of employment protection legislation (EPL) discussed in the main text. The analysis suggests that the higher the stringency of regulations, the greater the likelihood that employers will report that labor regulations are a major obstacle. In other words strict labor regulations, even if not fully enforced, affect firms' performance by limiting the opportunities open to managers. Both small firms and large seem to be less concerned with labor regulations; medium-sized firms are most affected. And firms downsizing are more likely than the average to report that labor regulations are a major obstacle. This suggests that labor regulations are more problematic for employers who face a crisis and have to lay off workers. Employers whose business is expanding are on average less concerned.

#### **The perception of the burden of labor regulations varies across countries and firms**



<sup>57</sup> See Nicoletti and others (2001) for the evidence on the relationship between R&D and labor regulations. See Scarpetta and others (2002) and Scarpetta and Tresselt (2003) for evidence of the impact of employment protection on productivity and entry rates.



*Creative destruction.* Stringent regulations also have repercussions on the turnover of firms in the market. Since new firms are often better at harnessing new technologies than incumbent firms, the regulations reduce the potential for productivity gains. Micro data for 19 industrial and developing economies suggest that countries with flexible hiring and firing rules experience significantly higher entry rates of small firms (but not micro enterprises, often exempt from such regulations or managing to avoid them). Stringent rules also tend to discourage foreign direct investment, especially in countries where rules are opaque and enforcement is uncertain.<sup>58</sup>

*Self-employment and informality.* Strict labor rules are associated with larger proportions of self-employed, informal firms, and small firms.<sup>59</sup> Firms facing high labor adjustment constraints either remain very small—and more or less informal and thus exempt from employment regulations—or move to a higher scale, at which hiring and firing costs play a smaller role in total expected adjustment costs. Information from the World Bank's Productivity and Investment Climate Surveys also suggests greater use of training by large firms to adjust the internal workforce. These firms may also be able to obtain special treatment from local or national authorities to circumvent rigid rules, or exploit their bargaining power. In Russia many large firms have circumvented strict regulations by encouraging workers to leave the firm voluntarily, through wage arrears, prolonged

<sup>58</sup> See Görg (2002) and Dewit, Gorg, and Montagna (2003) for evidence of the effects of employment protection on FDI.

administrative leaves, reduced hours, and other forms of deteriorating working conditions. With no future in the firm and no source of income, many workers eventually quit.<sup>60</sup>

*Winners and losers from stringent employment protections.* To the extent overly restrictive regulations reduce the potential for firm expansion and job creation, they also impede workers' access to jobs. More job stability for some may imply fewer job opportunities for others. So it is not surprising that stricter job protection rules do not lead to a more equal labor market. If anything, income disparities are greater in countries with stricter regulations.<sup>61</sup>

Strict regulations in industrial countries, where enforcement is high, tend to promote job stability for prime-age males, but tend to reduce job opportunities and lengthen unemployment spells for youths, women lacking work experience, and those with low skills.<sup>62</sup> Firms may become reluctant to hire new workers from these groups for fear of incurring expensive dismissal costs in the future. It is not surprising that the incidence of long-term unemployment (more than 12 months without a job) is very low in the United States (6 percent of total unemployment) and other countries with moderate employment protection legislation, while it is more than 50 percent in Belgium, France, Italy and Spain, which have stricter labor regulations.

When enforcement is weak, as it is in many low and middle income countries, stringent regulations do not reduce the size of labor reallocation, but they do change its nature and reduce its effectiveness. In Argentina—a country with fairly rigid labor regulations—job flows had a negative contribution to aggregate productivity growth in the past decade, as many workers transited from formal jobs to lower productivity jobs in the informal sector.<sup>63</sup> In some transition countries lagging behind in market-oriented reforms,

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<sup>59</sup> See Nicoletti and others (2001) on self-employment; Nicoletti and others (2001) for the evidence on firm size; and Scarpetta and others (2002) for the evidence on size of entrant firms and post-entry expansion.

<sup>60</sup> According to a recent study, nonpayment of contractual obligations, or wage arrears, spread to nearly 60 per cent of all workers in Russia in 1998 and, despite declining, continues to affect a significant share of the workforce; see World Bank (2003e).

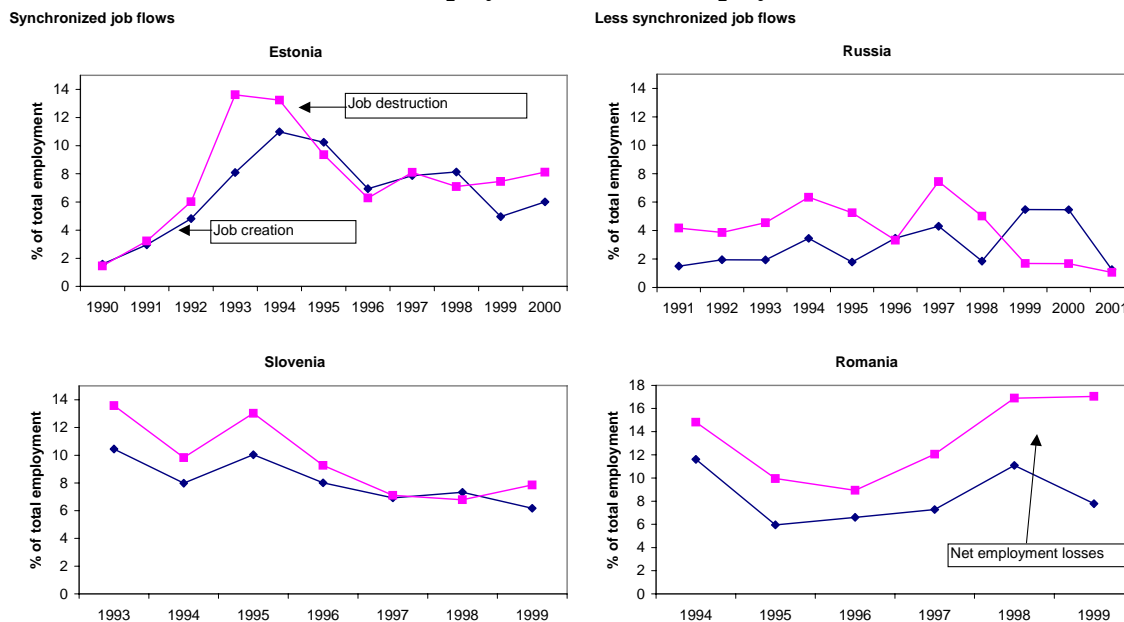
<sup>61</sup> See Pagés and Montenegro (1999), and Montenegro and Pagés (2004) for Latin America. Djankov and others (2003), using a sample of 85 countries, suggest that an increase of 1 point in their employment laws index (from 0.76 to 2.40) is associated with an increase in the share of the unofficial economy in GDP of 6.7 percentage points and an increase in the share of unofficial employment of 13.8 percentage points.

<sup>62</sup> See Addison and Teixeira (2001) and Nickell and Layard (1999) for surveys of the literature for industrial countries.

<sup>63</sup> See Cavalcanti (2003), Mondino and Montoya (2004).

stringent labor regulations have not prevented job destruction, instead discouraging job creation in the formal economy. This has led to job destruction leading job creation (or highly unsynchronized job flows) and the buildup of a large pool of unemployed or informal workers (Figure 13). Women, youths, and the unskilled—facing greater difficulties in obtaining a job in the formal sector—are more frequently unemployed or engaged in informal activities.

**Figure 13: If job creation and destruction are not synchronized, they may give rise to unemployment or underemployment**



Source: Bartelsman and others (2004), Brown and Earle (2004).

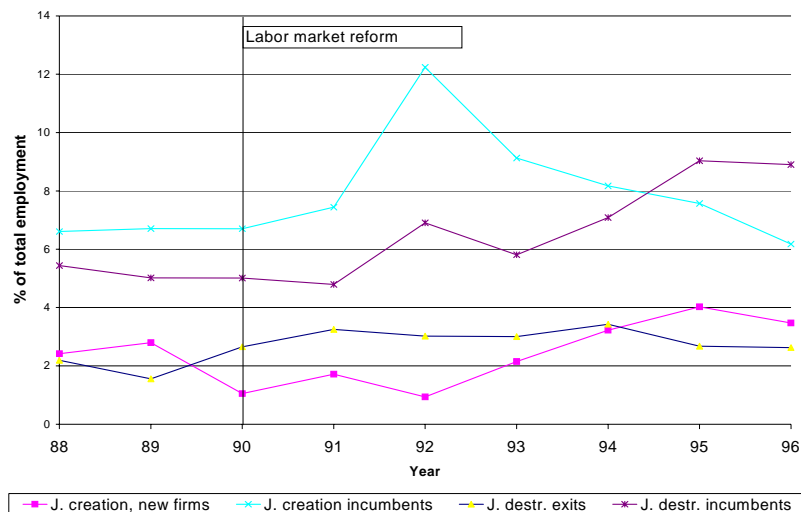
### ***Promoting labor reallocation and the formalization of work relations***

Evidence from a few countries that have recently changed job security regulations illustrates the potential benefits of reforming overly stringent labor legislation.

*Reducing labor adjustment costs.* Colombia and Peru liberalized their employment protection in the 1990s, moving their legislation closer to the standards of the (still quite regulated) European industrial countries. The reforms led to a higher response of employment to output growth, with speedier employment adjustment but also positive employment effects. In Colombia the reform also contributed to increased compliance with labor legislation by lowering the costs of formal production (Figure 14). Spain and Italy also experienced sizable positive effects on employment associated with some easing of their very

restrictive firing regulations during the past decade.<sup>64</sup> A study in India suggests that amendments to the strict employment regulation in one state (Andra Pradesh) in the 1980s allowed 1.8 million urban poor to find a job in manufacturing and service companies in the next decade. By contrast, in another Indian state (West Bengal) about 2 million poor people would have found jobs had the state not passed stricter regulations on dismissal and work hours over the past decades.<sup>65</sup>

**Figure 14: Since the labor reform of 1990, there has been a higher job turnover at incumbent firms and stronger job creation at new firms in Colombia**



Source: Bartelsman and others (2004).

Liberalizing temporary contracts: blessing or curse? Several countries in Continental Europe and more recently in Latin America and especially in Central and Eastern Europe have also tried to increase the adaptability of the labor market by liberalizing fixed term contracts and temporary work. Business surveys in many developing and transition countries suggest that firms facing strict regulations of permanent contracts make greater use of temporary employment to foster the adaptability of their workforce.<sup>66</sup> However, liberalizing temporary contracts while leaving in place strict regulations on permanent

<sup>64</sup> See Kugler and Pica (2003) for evidence in Italy.

<sup>65</sup> See Besley and Burgess (2004).

<sup>66</sup> See Pierre and Scarpetta, Background note for the World Development Report 2005. In South Africa, more than 90 % of large firms report to make greater use of temporary workers in order to increase flexibility of the workforce; and 50% of them reduce, at the same time, the share of permanent workers (see Chandra and others (2001)). Interestingly, while about one-third of formal micro enterprises use temporary employment, the share is less than 10% amongst informal firms (Chandra and others (2001)).



contracts reinforces the inequality in the labor market, with negative consequences for firms' performance. Firms will have stronger incentives to hire more workers at the entry level, employ them for a limited period without giving them a permanent position thereafter. This increases job turnover but not necessarily overall employment or productivity, as the additional hires will be accompanied by additional layoffs at the end of the temporary contracts and there will be no, or little, development of the internal human capital.<sup>67</sup>

### ***Synergies between reforms in labor and other markets***

The insider power of workers employed in firms sheltered from competitive pressures (either by legal, administrative, and trade restrictions or by public ownership) can be compounded by unduly restrictive employment protection, pushing up wage premia and lowering output and employment. In this context, improving property right protection can have large implications on labor supply and workers' productivity. For example, issuing property titles to urban households in Peru led to a major increase in the labor supply, with shifts away from work at home to work in the market and to substitution of adult labor for child labor.<sup>68</sup>

The effects of regulatory reform are likely to differ depending on the initial combination of regimes and on the sequencing of the reforms in product and labor markets. Evidence suggests that high job security may lead to adverse effects of trade liberalization on the coverage of labor laws and social protection: in highly regulated labor markets, trade reforms may lead employment shifts from jobs covered by labor law to jobs not covered.<sup>69</sup> Colombia's trade liberalization was associated with increased informal employment in industries with the largest tariff cuts, but once labor market reforms were introduced this

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<sup>67</sup> Evidence from France, Spain, Argentina, Peru and Colombia suggests that the asymmetric liberalization of contracts has led to significant shifts towards precarious jobs. In Argentina and Spain these reforms were reversed after a few years and, in the latter country, net job creation has really picked up only after the government reformed permanent contracts in the mid 1990s. In Spain temporary employment reached almost one-third of the total workforce after the reform of temporary contracts in the mid-1980, Dolado, García-Serrano, and Jimeno (2001). In Peru, the liberalization of temporary employment in the early 1990s led to an increase in temporary employment from 20 in 1990 to 55 per cent in 2000. In Colombia there was a similar large increase, Saavedra (2003). See also Blanchard and Landier (2001) for France and Hopenhayn (2004) for Argentina.

<sup>68</sup> See Field (2002).

<sup>69</sup> In this context, Agénor (1996) argues that the effectiveness of structural adjustment programs in developing countries is affected by the specific characteristics of their labor markets.

pattern was reversed. Similarly, Indian states with less stringent labor regulations experienced stronger growth in the formal sector than those adopting stricter labor regulations.<sup>70</sup>

### **3. Helping workers cope with insecurity and promoting entrepreneurship**

In a world where from 20 to 30 per cent of existing jobs are created or destroyed in any given year, how to insure against the cost of job loss and how to facilitate the access to a new one become key priorities for policy makers. Dealing with labor mobility and the associated economic insecurity requires a comprehensive approach. From an individual perspective, there are three main strategies of dealing with economic risks: i) preventive measures to reduce the occurrence of a shock (e.g. unemployment) or its effects (long duration of joblessness) for example by investing in human capital throughout the working life<sup>71</sup>; ii) mitigating the risk, for example by holding multiple employment (often with detrimental effects on specialization and future earnings); or pooling the risk across individuals through formal (such as unemployment insurance) or informal insurance (such as private transfers); or pooling the risk across time such as self-insurance through precautionary savings in good times; and iii) coping with the shock once occurred, often with non-optimal reactionary strategies such as recurring to child labor. The ex-ante measures of dealing with the risk – prevention and mitigation – in many cases call for individual pro-activity and can be based on provisions by the private sector, but require, in all cases, appropriate government regulation and supervision. In some instances, such as unemployment insurance, public mandating or public provision and financing is required. Social assistance –including cash transfers (with build-in work incentives), in-kind benefits and services – are risk coping mechanisms that allow governments to reduce the impact of a negative income shock, especially amongst those who are less able to protect against them -- informal workers and the poor.

Mandated provision of unemployment benefits to the unemployed or under-employed is required because such programs cannot be handled efficiently by private

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<sup>70</sup> See Goldberg and Pavcnik (2003) for Colombia and Aghion and Burgess (2003) for India.

<sup>71</sup> See de Ferranti *et al.* (2000), Holzmann and Jorgenson (2001), and World Bank (2001b and 2003c) for an extensive discussion on social risk management.

providers given strong information asymmetries and the associated moral hazard and adverse selection problems. Moral hazard arises because unemployment insurance reduces self-protection; adverse selection arises because information problems prevent insurers from charging higher premiums to bad risks compared with poor risks. Correcting for market failures calls not only for regulation in the form of obligatory membership to avoid the problem of adverse selection, but also for its public provision, to improve monitoring capacity and financial sustainability of the program. Public provision of social risk management programs also enhances the ability to pool resources across large groups, lowering the strain on the system arising from the covariant nature of unemployment risk.

The potential benefits of social risk management programs go well beyond the welfare of the unemployed or the poor but potentially enhance efficiency and the proper allocation of resources. First, social insurance schemes can stimulate the emergence of more risky, but more productive, jobs and industries.<sup>72</sup> The few available estimates suggest that the potential gain in income levels through access to appropriate risk management instruments may be sizeable. Bringing insurance to similar levels to those of richer households could raise average incomes of the un-protected poor by about 25 per cent (in rural Tanzania) to 50 per cent (in a sample of rural villages in India).<sup>73</sup> Second, it can be argued that uninsured transient shocks which reduce individual consumption below a threshold needed to retain productivity can give rise to “dynamic poverty traps” and lead to chronic poverty. This can happen when families are forced to sell productive assets used to support their agricultural or micro-enterprises.<sup>74</sup> Third, uninsured risk also reduces efficiency through costly production and portfolio choices, such as the use of outdated but less risky production technologies, or holding livestock as a form of precautionary savings. Fourth, uninsured risk can adversely affect human capital accumulation, for example, when children are forced to drop out of school in the wake of an income shock in the household.

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<sup>72</sup> See for example, Acemoglu and Shimer (1999).

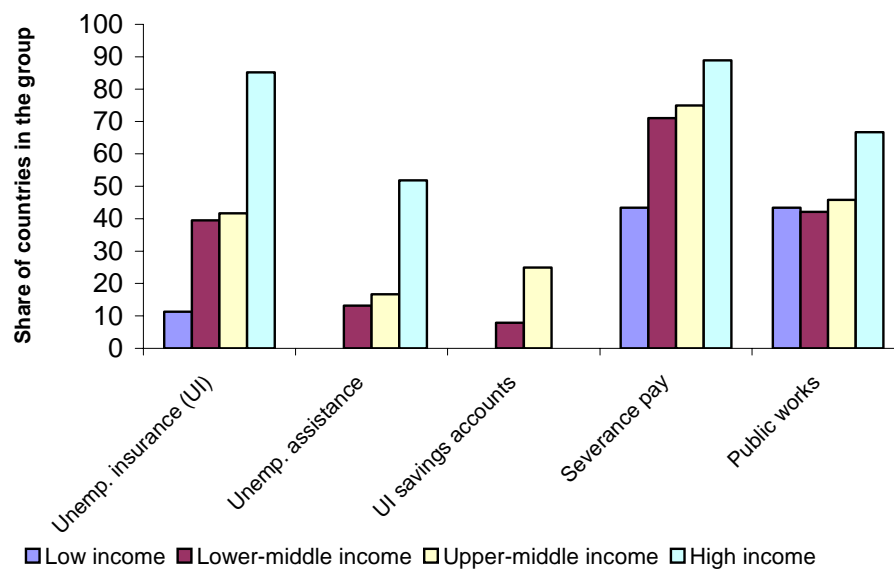
<sup>73</sup> The results for Tanzania are drawn from a comparison of households with limited liquid asset (livestock) compared with wealthier ones. The former tend to grow proportionally more sweet potatoes, a low return, low risk crop than the latter (see Dercon 1996). The evidence from India is based on data on the portfolio of activities and investment in the Indian ICRISAT villages; reducing rainfall timing variability (via some mechanism of insurance) is estimated to have a large effect on farm profits of the poor households (Rosenzweig and Binswanger, 1993).

<sup>74</sup> See, e.g. Ravallion (2003).

Finally, unemployment benefits may provide necessary resources to increase the effectiveness of the job search, or to enter self-employment.<sup>75</sup>

Providing income support and help in finding a new job may not only be beneficial for the workers themselves—it may also promote economic efficiency insofar as it enables better matches between workers’ abilities and the requirements of new jobs. In many low and middle income countries, inadequate or non-existent social insurance mechanisms imply that dismissed workers cannot afford to remain without income and are forced to accept the first job that comes their way, even if it is not good or productive (Figure 15).

**Figure 15: Developing countries, particularly low-income ones, offer a much weaker and less diverse protection against unemployment risk than developed countries**



Source: Vodopivec (2004).

Note: Based on the presence of the following programs: Unemployment insurance, unemployment assistance, unemployment insurance savings accounts, severance pay, and public works.

<sup>75</sup> According to Klasen and Woolard (2001), the absence of unemployment benefits in South Africa affects household formation and residential choices in ways that are detrimental to job finding. The system forces the unemployed to base their location decisions on the availability of economic support – generally available in rural areas, often in parental households – rather than on the availability of job openings. Klasen and Woolard thus conclude that the absence of unemployment benefits may not only lower welfare of the unemployed and their dependents, but it may also not reduce unemployment duration – and may actually increase it.

Improving policy performance in this area requires progress toward three interrelated objectives.

- Helping workers cope with large restructurings
- Reinforcing insurance mechanisms that help workers cope with the income losses of job dislocation and promote their entrepreneurial capacity.
- Reaching out to the large share of workers in rural and the informal sectors who generally cope with risks after they have occurred, often resorting to unproductive strategies.

### ***Helping workers cope with large-scale restructurings***

Mass layoffs occur often during public sector reforms, when large state-owned enterprises go through a downsizing of their workforce. There are, however, other circumstances that force large firms to significantly reduce their workforce. In the infrastructure sector, many vertically integrated power companies have been restructured into separate companies for generation, supply and distribution. Likewise, former monopolistic utility providers have been exposed to increased competition or challenged by new regulations, and have restructured their production to respond to these pressures. New technologies also lead to job losses in traditional enterprises. For example, containerization in ocean shipping has reduced the handling time of shipment and the need for port labor and ship capacity; mobile telephone companies are increasingly challenging large fixed-line operators; and the development of internet communications is challenging conventional post services.

There is often strong pressure to compensate groups more directly threatened by structural reforms, such as workers of previously protected industries who enjoyed large rents and job security. Typically not poor, these groups are very vocal and could represent concentrated opponents to reform. Providing significant one-time compensation to them may, thus, be a socially efficient strategy to push reforms ahead.

Workers affected by large-scale dismissals face specific difficulties. While those with high skills are likely to find a new job even before becoming redundant, those with low

qualifications, or with skills which are no longer demanded, face the gloomy prospect of long unemployment spells and inactivity. Not only they may not find it easy to retrain and adapt to labor demand, but they are also likely to compete in thin labor market, especially when mass layoffs are concentrated in mono-cultural areas. These problems tend to be further complicated by the fact that many state-owned enterprises were used to provide their workers with an array of social services. For example, in transition economies, state-owned firms traditionally provided kindergartens and health services as well as cheap rental accommodation. Social services have often been discontinued in the aftermath of the privatization or restructuring, but many laid off workers often maintained the subsidized accommodation. This further discourages internal mobility, because workers not only face a very uncertain employment prospect in expanding areas, but also have to give up cheap renting for new accommodation at higher rental values.

The traditional approach to dealing with large dismissals is to promote voluntary departures with generous severance pay.<sup>76</sup> This approach tends to reduce labor's opposition and to minimize the short-term social impact of restructuring or downsizing. The challenge is to set severance pay at a level that will be attractive to workers yet financially sustainable. Too high a level can lead to high short-term costs and the adverse selection of the best employees leaving first. High costs may also slow or even stop the process of firm restructuring. In Ghana downsizing was halted because the government could not afford the severance payments. In the 1990s Pakistan made severance payments to workers affected by the privatization of industrial units that included five months' salary for each year of service – much higher than international norms. The agreement set a precedent for the later privatization of public utilities, raising the costs to unaffordable levels and delaying reforms.<sup>77</sup>

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<sup>76</sup> It is useful to note that some shocks are transitory, i.e. the prospects of workers to find a similar job in the near future are perceived as high. This transitory surplus of labor can be addressed directly by firms, within the premise of labor regulations, through temporary layoffs, cuts in working hours with partial compensation or pay cuts, Winter-Ebmer (2001). The discussion in this sub-section considers cases where structural changes lead to permanent layoffs and often necessitate government intervention.

<sup>77</sup> Kikeri (1998).

Governments can also provide specific retraining programs to help workers regain employment. But these programs often operate in a context of low labor demand that makes it difficult to identify the training curricula and to motivate workers to participate. In many cases, a low proportion of eligible workers takes up these courses,<sup>78</sup> which often come too late, after the downsizing has taken place and workers have already left, as was the case with the retraining Bangladesh provided for jute workers. In any event, for political and social reasons, it is likely that governments will provide such programs even if they are not highly effective. To make the most of them, their design matters and needs to be adapted to the country's circumstances. Early preparation is therefore essential, and targeted intervention helps to minimize problems. But where job demand is lacking, eliminating obstacles to private job creation through broader investment climate improvements is essential.

### ***Promoting entrepreneurship and efficiency***

Measures are needed to reduce exposure of labor to external and domestic shocks or, if this cannot be avoided, to mitigate the income effects on displaced workers. Sound macroeconomic policies and investments in education are the best risk-prevention instruments. Social protection programs can mitigate the impact of risks while promoting labor reallocation and entrepreneurship. Even if public resources to finance these schemes are limited, much can be done to promote their effectiveness by reinforcing insurance principles and better targeting.

The policy mix best suited to each country depends on the factors driving economic insecurity and the cost-effectiveness of the various options.<sup>79</sup> Three general principles emerge from international experience.

*Reduce economic volatility.* Many low and middle income countries remain exposed to external shocks and, given their limited international links, have limited capacity to accommodate them. When a negative aggregate shock hits the economy, capital—often the most mobile factor of production—tends to leave the country, while labor tends to bear

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<sup>78</sup> See Winter-Ebmer (2001) and Kikeri (1998).

<sup>79</sup> For more details see Holzmänn and Jorgensen (2001) and World Bank (2001b). See also World Commission on the Social Dimension of Globalization (2004).

the brunt of the adjustment in terms of either real wage cuts or unemployment and underemployment. Export diversification can reduce exposure to large fluctuations in external demand and deeper capital markets and stronger banking systems increase the ability to mitigate the impact. The welfare benefits from reducing macroeconomic volatility in most developing countries can be substantial.<sup>80</sup>

*Move away from pro-cyclical fiscal policy.* The exposure of workers to external shocks is also compounded by the fact that their governments often lack the fiscal discipline to promote countercyclical financing of social programs. Many governments tend to adopt an expansionary fiscal stance in good times and a contractionary stance in bad times. Mounting budget deficits in recessions thus creates pressures to reduce public spending on social protection (among other things) just when the need for it is increasing. Greater fiscal discipline and a better diversification of the fiscal revenue base are also essential elements to guarantee that resources are available to cushion the required labor adjustment process.

*Remove market inefficiencies.* Beyond macroeconomic policies, the most effective strategy for risk prevention and mitigation is to develop a sound investment climate where firms have incentives to invest and expand. Investment climate improvements allow for stronger job creation in the formal sector and greater resources available for social programs. They also provide greater opportunities for workers to insure themselves against job losses and promote their entrepreneurial potential.

### ***Promoting workers' adaptability and mobility***

Beyond the much needed improvements in the coverage and quality of formal education, governments can improve the ability and willingness of workers to move to more productive and rewarding jobs by supporting training, counseling, and placement services. The effectiveness of these programs has been challenged especially in countries with limited capacity, but when properly targeted they can be a complementary strategy to skill enhancements and income support.

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<sup>80</sup> Estimates suggest that had Latin America and the Caribbean been able to diversify their *idiosyncratic* aggregate volatility in the 1990s they would have enjoyed a 7 per cent higher consumption, a figure that is six times as high as the expected gain for the OECD countries, de Ferranti and others (2000).



*Job search assistance* is aimed at promoting transparency and information in the labor market so as to facilitate job matching. In this respect, it offers a service to both employers who have otherwise to go through a lengthy and costly selection process and workers who may lack the information on suitable jobs in the market. To be effective, this program requires close links between employers, the intermediation office – generally public employment services and, increasingly in industrial countries, private agencies – and the job seekers. Taking advantage of a network of labor offices, the Czech Republic’s job brokerage program has been successful at reducing unemployment duration.<sup>81</sup> By contrast, in Brazil, where the network of employment services is less developed, most unemployed use personal channels to find a new job and often move to the informal sector while waiting for a better option in the formal economy.<sup>82</sup> In Uruguay, these schemes seem to be more useful for highly educated workers who have access to formal jobs than for low-skilled workers.<sup>83</sup>

*Labor market training* includes publicly supported programs, usually through either direct provision (in public training institutes) or financial support (funding training costs and/or subsidizing trainees).<sup>84</sup> In many countries, governments are moving away from the role of direct provision of training and focusing more on addressing market failures in information and financing, while leaving more of the delivery to private providers. Relying on a network of employment services that circulate information on skill needs training programs in Bulgaria, Poland, and the Slovak Republic increased the probability of leaving unemployment. In Mexico the Job Training Program for Unemployed Workers (PROBECAT) combines short-term training for unemployed and displaced workers with income support (at the minimum wage) and, more importantly, placement services from the local employment offices. Interestingly, on-the-job training is found to be more effective than classroom training, and private training centers seem to outperform government-run centers.<sup>85</sup>

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<sup>81</sup> Terrell and Sorm (1999).

<sup>82</sup> Woltermann (2002).

<sup>83</sup> Fawcett (2001).

<sup>84</sup> Middleton, Zideman, and Adams (1993).

<sup>85</sup> Calderon-Madrid and Belem (2001).

*Training programs for youths*, even when well targeted, tend to have a poor track record. Interventions typically include some combination of on-the-job training, vocational (classroom) training, job readiness training, and/or internships. However, earlier interventions at the schooling stage are likely to be more effective than trying to remedy education failures.<sup>86</sup> The experience of some Latin American countries offers some interesting insights. The “Jovenes” programs in Argentina, Chile, Peru, and Uruguay are targeted at disadvantaged youth—combining training and work experience with other services including psychological development, and vocational assessment. While effective in promoting employability of the targeted youths, the programs tend to be costly. The evaluation in Argentina estimated that at least nine years of higher earnings due to the program would be required to show a positive net present value for the groups with statistically significant results.<sup>87</sup>

### ***Reinforcing social insurance***

Beyond improving the welfare of the unemployed, effective social insurance programs improve the investment climate by facilitating the allocation of resources to more productive uses and encouraging entrepreneurship. First, social insurance schemes can stimulate riskier but more productive jobs and industries.<sup>88</sup> It is estimated that lack of access to insurance amongst poor rural households pushes them to take up low-risk activities with lower returns, reducing their income potential by 25 percent in rural Tanzania and by 50 percent in a sample of rural villages in India.<sup>89</sup>

Second, uninsured transient shocks that reduce individual consumption below a threshold needed to retain productivity can give rise to “dynamic poverty traps”. This happens when families are forced to sell productive assets needed to support their

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<sup>86</sup> Betcherman, Olivas, and Dar (2003).

<sup>87</sup> Aedo and Núñez (2001).

<sup>88</sup> Acemoglu and Shimer (1999) suggest that moderate levels of unemployment benefits help improving job matches with positive effects on productivity and output growth.

<sup>89</sup> The results for Tanzania are drawn from a comparison of households with limited liquid asset (livestock) compared with wealthier ones. The former tend to grow proportionally more sweet potatoes, a low return and low risk crop than the latter, see Dercon (1996). The evidence from India is based on data on the portfolio of activities and investment in the Indian ICRISAT villages; reducing rainfall timing variability (via some mechanism of insurance) is estimated to have a large effect on farm profits of the poor households, Rosenzweig and Binswanger (1993).

agricultural or microenterprises.<sup>90</sup> Third, uninsured risk also reduces efficiency through costly production and portfolio choices, such as the use of outdated but less risky production technologies, or holding livestock as a form of precautionary savings. Fourth, unemployment benefits may provide necessary resources to increase the effectiveness of the job search or to enter self-employment.<sup>91</sup>

*Reinforcing self-insurance among formal workers.* In most low and middle income countries, mandatory severance pay provisions are the prevalent form of insurance against unemployment for workers in the formal sector. Generally easy to administer, the provisions exchange resources, in the event of unemployment, for an “insurance premium.” As discussed earlier, whether the premium translates into lower wages affects labor costs for firms and their incentive for hiring. But the schemes do offer a limited pooling of unemployment risk because they are firm-specific and because the premium generally evolves with tenure and not with the risk of unemployment.<sup>92</sup>

Severance pay provisions suffer from noncompliance in many countries, increasing workers’ resistance to leaving a job. Payments tend to increase when financial resources are lacking because the firm is experiencing difficulties, and they may simply not be available if the firm goes bankrupt. Noncompliance also creates a burden on labor courts and government budgets. For example, in Slovenia unpaid claims amount to more than one-third of total severance pay provisions. In Peru, not only are poor workers less likely to be entitled to severance pay, but they are less likely to receive it in case of dismissal.<sup>93</sup> In these circumstances, employment adjustments for economic reasons are impaired and workers are

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<sup>90</sup> See, e.g. Ravallion (2003) and World Bank (2002b).

<sup>91</sup> According to Klasen and Woolard (2001), the absence of unemployment benefits in South Africa affects household formation and residential choices in ways that are detrimental to job finding. The system forces the unemployed to base their location decisions on the availability of economic support – generally available in rural areas, often in parental households – rather than on the availability of job openings. They conclude that the absence of unemployment benefits may not only lower welfare of the unemployed and their dependents, but it may also not reduce unemployment duration – and may actually increase it.

<sup>92</sup> de Ferranti and others (2000) argue that, when Latin American countries had little exposure to foreign competition, the effective pooling of unemployment risk offered by severance pays was spread over a greater population, as consumers often times subsidize potentially bankrupt firms through higher prices. However, this possibility has declined rapidly as countries have embarked on trade liberalization and reforms aimed at fostering domestic competition.

<sup>93</sup> See Vodopivec (2004) for Slovenia and MacIsaac and Rama (2001) for Peru. See Gill *et al.* (2002b) for a discussion of severance payment in other Latin American countries.

deterred from seeking better job matches. It looms particularly large among small firms and among low-skilled workers who have few alternative instruments to smooth consumption. To tackle these shortcomings, some countries have introduced pre-funding or reduced the generosity of payments to bring them more in line with international experience. Colombia moved toward a funded system under individual savings accounts in 1990 and Chile introduced a social-insurance component to its system in 2002 (see Box 6).

**Box 6: Reforms of the severance pay: reducing labor market distortions and enhancing insurance**

In 1990 **Colombia** introduced a system of fully-funded severance pay savings accounts which required employers to deposit a percentage of wages into guaranteed individual accounts available to workers in the event of job separation (limited access to funds while employed was also foreseen). The reform reduced labor market distortions and promoted job creation. Employers shifted most of the severance payments' costs onto wages, but total compensation of workers (wages plus deposits to their savings accounts) increased. In addition, because the reform removed the discretionary nature of severance payments, both separations and accessions increased.

By transforming uncertain and conditional payments to unconditional payments monitored by the third party (the government), the reform also enhanced insurance function of the severance pay. Before the reform, non-performance of the severance pay was a big problem (for example, firms about to go bankrupt could simply not pay severance or could negotiate a package substantially below what was owed in severance payments). Thanks to the pre-funding requirement, the reform increased the likelihood that the legal entitlement to severance pay is actually carried out. The new severance pay savings accounts strongly reduced in-kind and monetary transfers from relatives, as well as government-mandated transfers, received by severance payments beneficiaries.

In 2002 **Chile** introduced a new, innovative unemployment insurance system which combines social insurance with self-insurance. Employers and employees both contribute to individual savings accounts but an additional contribution from employers and a small public subsidy are allocated to a Solidarity Fund. The new program is effectively a funded system, with funds on individual accounts being managed by a freestanding administrator selected through a competitive tender.

To stimulate reemployment, benefit recipients first draw resources from their own accounts, and upon depletion from the solidarity account. Withdrawals from individual accounts are triggered by separation from the employer, regardless of the reason. Withdrawals from the common fund are triggered by insufficient resources on individual accounts, if the claimant satisfies the usual conditions of continuing eligibility under unemployment insurance (such as not working and being available and searching for job), but are limited to 2 withdrawals per 5 years. Benefits are linked to past earnings, with a declining schedule. Moreover, workers can move any unused savings from their individual accounts to their old-age pension accounts on retirement.

*Source: Vodopivec (2004); Kugler (2002, 1999); Acevedo and Eskenazi (2003).*

*Increasing the pooling of risks across workers.* Evidence from industrial countries suggests that unemployment insurance benefits are the next natural step to pool unemployment risks and promote labor reallocation.<sup>94</sup> Most transition countries, following this model, have had unemployment insurance schemes since the early 1990s. The schemes have been the main source of income for workers affected by labor reallocation during the transition. For instance, more than two-third of the households with at least one unemployed worker received such benefits in Hungary and Poland in the mid-1990s (see Vodopivec, Wörgötter, and Raju, 2003). The clear welfare gains for workers affected by job loss have to be weighed against the costs of these schemes and their impact on economic efficiency. Both depend largely on the ability to monitor eligibility requirements to minimize moral hazard and make sure that workers have incentives to actively search for a new job.<sup>95</sup> But effective enforcement is difficult in developing countries, which generally have weak public employment services or none, compounded by a large informal economy that offers many opportunities for undeclared paid work. The capacity to monitor continuing eligibility has been lacking in Argentina, for example, making unemployment benefits a mere cash transfer program.

Even if countries have the required administrative capacity, unemployment benefits should provide only a fraction of the previous wage—and they should be short-lived, to provide incentives for beneficiaries to seek a new job. Poland introduced a generous and open-ended unemployment insurance schemes in the early 1990s, offered to all job seekers irrespective of whether they had lost their job or not. Not surprisingly, the number of claimants soared, making the system financially unviable and contributing to the buildup of a large pool of long-term unemployed. The scheme was subsequently reformed on several occasions to reduce disincentive effects, and now provides a low flat benefit for a limited duration. The Czech Republic, by contrast, opted for less generous short-lived benefits (only six months) and, partly because of this, had comparatively lower unemployment in the early phases of the transition.

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<sup>94</sup> Gruber (1997) finds that in the absence of unemployment insurance, average consumption expenditures would fall by 22 percent.

<sup>95</sup> See Martin and Grubb (2001) for a review of the experience of unemployment insurance schemes in industrial countries.

### *Combining income support for the poor with improvements in local investment conditions*

Most of the programs discussed in this section fail to reach rural workers and those in the informal economy. Traditionally, these workers have relied on private transfers to cope with shocks. Informal commitments by employers to provide a minimum form of insurance to workers have historically been an important part of socially acceptable codes of conduct, especially in rural areas.<sup>96</sup> As part of these commitments, employers often agree to pay workers a fixed wage while they remain employed, regardless of the seasonal or other fluctuations in demand. Moreover, it is not infrequent that employers provide loans to workers who face unexpected expenses. Given the informality of the employment contract, these commitments give employers a lot of discretion. Households also rely on their own savings and private transfers to cope with shocks. Evidence from Indonesia, the Philippines, and Russia suggests that private transfers account for between 2 and 41 percent of income for net receivers and between 1 and 8 percent of income for net givers.<sup>97</sup> A study in Kyrgyzstan found that private transfers are provided to just 12 percent of the households but account for more than one-third of the incomes of the households who receive them.<sup>98</sup>

These forms of private risk-coping mechanisms are becoming less effective in sheltering poor and informal workers from risks. Market economies require significant movements of labor, including in the informal or rural sector, which potentially weakens long-term relationships between employers and employees and makes voluntary risk-sharing and informal insurance commitments less effective. In some countries, shocks have also become more severe, often more recurrent and difficult to anticipate, especially for those with low skills and experience—all reducing the potential for private transfers. For example informal transfers are estimated to offer little protection during shocks or periods of covariate risk: they are estimated to account for less than 10 per cent of the size of typical income shocks in bad periods in India; and in the Sahel region, following the 1984 drought, transfers comprised less than 3 percent of the losses of the poorest household (Morduch, 1999).

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<sup>96</sup> See World Bank (1995) – WDR.

<sup>97</sup> See Tabor (2002).

<sup>98</sup> See Cox *et al.* (1994). The authors estimate that that poverty incidence would be 25 percent higher among those receiving transfers had they not received them.

Under these circumstances, substituting a public “safety net” for a private coping system can help individuals and their families cope with severe income losses and encourage their entrepreneurial drive. It can also break a vicious circle in which the household, to accommodate a temporary income loss, takes actions that undermine its future ability to cope with shock, such as taking children out of school or cutting health expenditures. For example, the financial crisis of the second half of the 1990s in the Philippines and in Indonesia triggered the entry of secondary income-earners into the labor markets – particularly of youths, resulting in significant declines in high school enrollment rates.

Three forms of “conditional” income support have been used in developing countries to provide a public safety net to poor people and to help improve the local investment conditions: workfare programs, social investment funds, and conditional cash transfers.

***Workfare programs to combine income support with improvement in local conditions for investment.***

Workfare programs have traditionally been the most widely used form of intervention to support poor households and promote local infrastructure development (for example in Bangladesh, India, Ethiopia, Kenya, Zimbabwe, South Africa, Tanzania, and Ghana). In many South Asia countries, workfare programs started as “food-for-work” programs in which workers were paid for their labor with food aid from Western countries. They have gradually moved to “cash-for-work” operated by a variety of agencies, including local and state governments and NGOs, and they are increasingly viewed as insurance—not emergency—programs for informal and rural workers. They generally transfer income to poor households, by providing unskilled manual workers with short-term employment on projects such as road construction and maintenance, irrigation infrastructure, reforestation, and soil conservation.

In most developing countries, workfare programs have been used to smooth consumption and keep poor people in contact with the labor market.<sup>99</sup> Well-designed workfare programs build much-needed infrastructure and thus minimize the tradeoff between

public spending on income transfers and on development. The Maharashtra Employment Guarantee Scheme in India, in operation for more than three decades, has created considerable irrigation, infrastructure, and rural roads in the state of Maharashtra.<sup>100</sup> Workfare programs have also helped many small private contractors to emerge and grow.

A key aspect of workfare programs is the ability of participants to self-select. In Chile and in Argentina (Trabajar), the program's wage rate was kept well below the minimum wage, encouraging the poor to self-select into the program. In the Philippines the program's wage was much higher than the agricultural market wage, and a substantial number of nonpoor were attracted into the program. Kenya, Malawi, Mali, and Senegal also paid wages above the market wage rates, undermining the self-targeting design and rationing jobs away from the very poor.<sup>101</sup> Self-selection of participants should be accompanied by targeting to the poorest areas to ensure that programs also promote local development. In South Africa a demand-driven approach in the allocation of funds for workfare programs has favored more developed and better connected communities at the expense of some of the neediest communities.<sup>102</sup>

### ***Social funds to improve the investment climate in poor areas***

Social funds, introduced in Bolivia in the late 1980s, have become one of the main tools of community-led poverty reduction. They finance small projects in poor communities. While the focus of early programs was on providing temporary work opportunities while also financing better access to basic services, recent programs have given greater emphasis on service delivering and connecting communities—which generally identify and partly finance projects—with local governments. Social funds now absorb close to \$10 billion in foreign and domestic financing in developing and transition countries.

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<sup>99</sup> See Ravallion (2003) for a survey; Ravallion and Datt (1995); Subbarao (1997); Teklu and Asefa (1999); Jalan and Ravallion (2003); Chirwa, Zgovu, and Mvula (2002).

<sup>100</sup> See Gaiha (2000).

<sup>101</sup> See Subbarao, Ahmed, and Teklu (1995) for the Philippines and World Bank (2002b) for the African countries.

<sup>102</sup> Haddad and Adato (2001) suggest little relationship between the district level share of public works activity and the district level share of poverty, unemployment and infrastructure need in a sample of 100 public works projects in the Western Cape of South Africa over the period 1995-97.



A recent review of social funds in Armenia, Bolivia, Honduras, Nicaragua, Peru, and Zambia offers a fairly positive assessment of their effectiveness in providing income support and promoting local development.<sup>103</sup> Evidence suggests that spending through social funds was highly progressive, with poor districts and poor households receiving more per capita support than wealthier districts or households.<sup>104</sup> Schools and health centers that received social investment funds have enjoyed equal or stronger access to staff and inputs and greater participation by local communities compared with other institutions. The effects on poor households can also be sizable. School infrastructure investment is estimated to have increased primary enrollment rates, especially in Armenia, Nicaragua, and Zambia. Likewise, in Bolivia social fund investments in health centers cut infant mortality rates in half. Finally, by involving community members in implementing and supervising projects, social funds may lead to cost-effective investment. In particular, the case studies reveal that where social funds allowed greater community control over decisions and resources, unit costs were lower (by 25 to 40 percent) and community co-financing was higher than in other programs. Where social funds worked through private contractors and government intermediaries, unit costs tended to be higher.

### ***Conditional cash transfers to preserve human capital and health***

Conditional cash transfers are another policy tool to combine income support with local development. They belong to a family of transfer programs that combine close targeting with capital accumulation by making income support conditional on either basic needs triggers, such as utility offset payments (in some transition economies), or behavioral changes, such as the continued school enrollment of children or attendance at health clinics. They typically address chronic poverty rather than idiosyncratic risks associated with job loss. Their focus on human capital formation makes them suitable to address poverty and local development at the same time. In Mexico (Progresa, which reached 2.3 million families in 1999), Brazil (Bolsa Escola and PETI) and Jamaica (PATH), conditional cash transfers are largely used to promote health and human capital of children. In some

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<sup>103</sup> See Rawlings, Sheburne-Benz, and Van Domelen (2003).

countries, these transfers are a quick response to economic crisis (Colombia) or a natural disaster (the earthquake in Turkey). In others, they meet long-term human development goals. For example, in Nicaragua, they were used to boost school enrollments.

Evaluations show that these programs can raise school enrollment and attendance rates and improve child health and nutrition.<sup>105</sup> The Mexican program (Progresa) increased primary school attendance by more than 2 percent and secondary enrollment by more than 8 percent, while increasing health visits by some 20 percent. The Brazilian *bolsa escola* reduced school dropouts from 5.6 percent to 0.4 percent.<sup>106</sup> The programs also tend to be better targeted than general subsidies by the use of proxy means testing and geographical targeting. They are highly transparent about who receives the transfers, and the level of benefits and the number of beneficiaries is easily adjusted in times of crisis. As with any transfer program, conditional cash transfers have problems, especially when the increased demand for services is not met by increased supply (schools or clinics) or when the targeting is not sufficiently resistant to outside influence.

#### **4. Concluding remarks**

Over the past two decades, the labor markets of most developing and emerging economies have been exposed to growing pressures to modernize and increase their adaptability. Available evidence suggests a significant degree of flexibility in most labor markets; with large numbers of jobs being created and destroyed every year and large real wage flexibility. But this flexibility cannot be fully associated to an efficient reallocation of labor to its most effective uses nor to a proper rewarding of workers. Workers flows often entail movements to the informal sector or to unemployment; and the observed real wage flexibility is often the result of an inadequate indexation of nominal wages to price hikes rather than appropriate wage negotiations, or to large wage losses by those changing job.

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<sup>104</sup> The percentage of beneficiaries beneath the national poverty line ranged from 71 percent in Zambia to 55 percent in Nicaragua. In the latter country, however, social fund spending on health and education was more progressive than general health and education spending.

<sup>105</sup> See Rawlings and Rubio (2002).

<sup>106</sup> See Sedlacek, Ilahi, and Gustafsson-Wright (2000). Bourguignon, Ferreira, and Leite (2002) also estimate a significant impact of the *Bolsa escola* on school enrollment, especially amongst the poor but, given the amount of the transfer, a little impact on the poverty incidence.

Better labor market outcomes depend on a complex set of factors that shape the investment climate in each country and promote sustainable growth and job creation in the formal sector. But labor market policy and institutions can play a role in promoting such a climate. Despite some improvements in the past decade, policy interventions in the labor market have often failed to promote an efficient allocation of resources, income and risks in the labor market. While many low- and middle-income countries have made significant progress in setting rules governing working conditions and the employer-worker relationships, the level of protection prescribed by law in many of these countries are often similar -- and in some instances even higher -- than the protection mandated in industrial countries. Overly ambitious labor regulations contribute to reduce the reallocation of labor towards productive jobs in the formal sector as they raise labor costs and curb incentives for firms to expand and hire more workers or to adopt new technologies. Other firms opt out and remain uncovered to maintain profitability, facing great uncertainty in their labor relations and constraints in their growth and job creation potentials. Improving the institutional fit of labor regulations with the economic reality of the different countries – and in line with the international experience – is one of the main challenges of labor reforms in developing and transition countries.

Reforms of labor regulations will face large resistance and may not succeed if they are not accompanied by improvements in social protection mechanisms that cushion adjustment costs for workers. In many developing countries, this task is currently hampered by a narrow tax base and a tendency for pro-cyclical fiscal spending which limits resources when they are most needed. Most social protection schemes only cover formal sector workers -- that is to say the non-poor -- and do not offer adequate protection against job losses even amongst those with a formal job. Rural and informal workers are often under the threat of unexpected illness, job loss, or poverty in old age. There are clear opportunities for improving the insurance component in income support schemes for formal workers and the pooling of risks across individuals. And innovative programs can also reach out to poor and informal workers who cannot be covered by broader insurance schemes. For example, in a number of countries, some new forms of income support and job creation have tried to shelter poor workers from major income losses by providing targeted cash transfers and

workfare programs. These programs only cover a minority of the poor, and tend to be exposed to budgetary cuts during downturns or economic crisis. While greater resources and better targeting of social protection interventions towards the neediest people are warranted to promote labor market adaptability, a better prospect for the poor requires a comprehensive intervention in the investment climate that promotes growth and job creation.

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### Summary Findings

To what extent have macro and structural reforms in many developing countries affected the labor market? Are current policy settings in the labor market adequate to cope with the current challenges of a more dynamic but also more risky economic environment? Are there examples of successful labor reforms that have combined greater adaptability with greater workers' protection? What can labor policy do when resources are scarce and informality looms large? These are some of the questions we address in this paper by presenting an in depth review of formal policy and institutional settings in the labor market of many developing and emerging economies. We also report some evidence of the effects of policy reforms on job creation and on the ability of workers to cope with shocks.

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